

No. 16663 ✓

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United States  
Court of Appeals  
for the Ninth Circuit

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O. H. KRUSE GRAIN & MILLING, a corpora-  
tion, Petitioner,  
vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

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Transcript of Record

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Petition to Review a Decision of The Tax  
Court of the United States

FILED

JAN 22 1960

FRANK H. SCHMIDT, CLERK



No. 16663

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Court of Appeals  
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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## NAMES AND ADDRESSES OF ATTORNEYS

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## The Tax Court of the United States

Docket No. 65683

O. H. KRUSE GRAIN & MILLING,  
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (Ap: LA:AA-DRR 90-D - ICA) dated October 29, 1956, and as a basis for its proceeding alleges as follows:

1. The petitioner is a corporation, with its principal place of business located at El Monte, California. The returns for the years involved herein were filed with the District Director of Internal Revenue for the 6th District California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on October 29, 1956.

3. The deficiencies, as determined by the Commissioner are in income tax for the calendar years 1952 and 1953, in the amounts of \$13,994.26 for the year 1952, and \$19,192.33 for the year 1953, all of which is in dispute.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors.

(a) The Commissioner erred in failing to find that the petitioner was indebted to O. H. Kruse in the principal sum of \$200,000. (two hundred thousand dollars), which indebtedness was evidenced by an interest bearing promissory note, and remained outstanding throughout the taxable years 1952 and 1953 involved herein.

(b) The Commissioner erred in failing to find that the said promissory note was issued by the petitioner to O. H. Kruse as the consideration for the transfer of certain properties by the aforesaid O. H. Kruse to O. H. Kruse Grain & Milling, the petitioner corporation involved herein.

(c) The Commissioner erred in failing to find that the said O. H. Kruse transferred to the petitioner corporation, for no stated consideration, the good will of the business previously built up by him; valuable contracts with various large groups of poultry producers; the benefits which could be expected from his friendly relations with the dairy companies which had furnished a substantial portion of the gross income of his former successful business, and commitments for purchases of grain at exceptionally favorable prices.

(d) The Commissioner erred in failing to find that the fair market value of the intangible assets transferred to the petitioner corporation for no stated consideration, was not less than \$200,000., (two hundred thousand dollars).

(e) The Commissioner erred in failing to find that the interest on the promissory note involved herein, which was issued by the petitioner to O. H. Kruse, in the principal sum of \$200,000.00 was paid to, or constructively received by O. H. Kruse during each of the taxable years 1952 and 1953, which are involved herein.

(f) The Commissioner erred in failing to find that the said O. H. Kruse reported the receipt of \$12,000.00 (twelve thousand dollars) in his federal income tax returns for each of the taxable years 1952 and 1953 involved herein, as interest on the petitioner's note.

(g) The Commissioner erred in failing to find that the petitioner was indebted to O. H. Kruse for the payment of rental for the use of leased real estate, in the sum of \$12,000.00 (twelve thousand dollars) for each of the taxable years 1952 and 1953.

(h) The Commissioner further erred in failing to find that the rental payments in the amount of \$12,000.00 owing to the said O. H. Kruse for each of the taxable years 1952 and 1953, were paid to, or constructively received by O. H. Kruse in each of those years.

(i) The Commissioner erred in failing to find that O. H. Kruse reported the amount of \$6,000.00 (six thousand dollars) for the year 1952, and \$12,000.00 for the year 1953, in his federal income tax returns for those years, as rental income received from the petitioner.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner is a corporation organized on

March 27th, 1950, under the laws of the State of California, to take over a business previously conducted by O. H. Kruse for many years prior thereto, as a sole proprietorship.

(b) The statement of the assets and liabilities of the business formerly conducted by O. H. Kruse, as shown on the books of account of the sole proprietorship, at March 31, 1950, discloses the following:

ASSETS:

Current Assets:

Cash in bank .....	\$ 42,681.22*
Cash on hand .....	2,937.41
Accounts Receivable .....	139,506.62
Inventory .....	37,724.59
<b>Total Current Assets .....</b>	<b>\$222,849.84</b>

Fixed Assets:	Cost	Reserve for Depreciation	
Land and buildings .....	\$ 35,179.85	\$10,767.74	
Machinery .....	64,113.91	20,377.65	
Automobiles & trucks .....	57,135.27	23,257.71	
Office equipment .....	1,865.76	415.05	
<b>Total .....</b>	<b>\$158,294.79</b>	<b>\$54,818.15</b>	<b>103,476.64</b>
Prepaid Expenses .....			6,457.15
<b>Total Assets .....</b>			<b>\$332,783.63</b>

LIABILITIES:

Current Liabilities:

Accounts Payable .....	\$ 1,710.00
Accrued Payroll Taxes .....	82.23
<b>Total Current Liabilities .....</b>	<b>\$ 1,792.23</b>
Note Payable—Fred J. Schroeder .....	8,000.00
<b>Total Liabilities .....</b>	<b>\$ 9,792.23</b>

\* Bank balance after paying all trade accounts as of March 31, 1950.

CAPITAL:

Capital—January 1, 1950 .....	\$291,143.51	
Add income to March 31st .....	39,013.70**	
	<hr/>	
	\$330,157.21	
Less: Drawings .....	7,165.81	322,991.40
Total Liabilities and Capital .....		<hr/>
		\$332,783.63

(a) Under date of July 13, 1950, the said O. H. Kruse transferred his business, and substantially all of the assets employed therein, subject to its then liabilities, to a corporation organized by him under the laws of the State of California, with the name "O. H. Kruse Grain & Milling," the petitioner herein.

(b) The name, "O. H. Kruse Grain & Milling" was adopted in order to retain the use of the valuable good will which had been developed by the said O. H. Kruse, in the course of his conduct of the business as a sole proprietorship, and to reassure important large customers, of long standing, that he intended to be actively associated with the new corporation, and they could rely upon a continuance of the treatment which had been extended to them, by him, prior to incorporation.

(c) The assets listed on the statement of assets and liabilities set forth hereinabove, which were exchanged for the capital stock of the petitioner corporation, were as follows:

---

\*\* Estimated federal taxes on \$39,013.70—\$12,500.00.

Office equipment .....	\$ 1,865.76	
Autos and trucks .....	57,135.27	
Machinery and equipment .....	64,113.91	
		\$123,114.94
Less: Accrued depreciation .....	44,050.41	
		\$ 79,064.53
Prepaid insurance .....	4,163.67	
Insurance deposits less accrued premiums .....	2,293.48	
Cash .....	4,270.55	
		\$ 89,792.23

(d) The capital stock of the petitioner corporation which was issued for the assets of O. H. Kruse totalling \$89,792.23 was of the par value of \$80,000.00.

(e) In addition to the above-listed assets, for which the petitioner issued its capital stock, the said O. H. Kruse transferred to the petitioner, without consideration, the good will of the business previously built up by him; valuable contracts with groups of large raisers of poultry for the sale of feed; valuable contacts with various dairy companies which furnished a large portion of his business, and commitments for purchases of grain at exceptionally favorable prices. The value of such intangible assets was not less than \$200,000.00.

(f) The petitioner was not an under-capitalized corporation.

(g) The principal remaining assets of O. H. Kruse, which were not transferred to the petitioner corporation in exchange for its capital stock, consisted of the following:

Cash .....	\$ 41,348.08
Accounts receivable .....	139,506.62
Merchandise inventory ....	37,724.59
	<hr/>
	\$218,579.29

As an integral part of a single transaction, and, on the same date that the other assets were transferred to the petitioner corporation in exchange for its capital stock, or, as a paid in surplus, the said O. H. Kruse conveyed the above-listed assets to the petitioner corporation in exchange for its promissory note in the principal sum of \$200,000.00 (two hundred thousand dollars), made payable December 31, 1950, and bearing interest at the rate of 6% per annum, in the event that it was not paid off on the said due date, and an open account due him from the petitioner in the amount of \$18,579.29.

(h) Since the petitioner failed to pay its note when due, on December 31, 1950, interest was regularly accrued, and/or paid on the said note for each year commencing with January 1, 1951, and including the taxable years involved herein, 1952 and 1953.

(i) The Corporate Minutes of the petitioner contain provisions for the application of payments by it to O. H. Kruse, and state that they must first be applied against interest on the said promissory note in the principal sum of \$200,000.00.

(j) Although the corporation was financially able to pay the interest due to the said O. H. Kruse for the year 1952, which had been accrued on its books, since he was not then in need of any funds for his

personal use, he did not insist on payment, which he could have done, by reason of being in control of the petitioner corporation. He did report the amount of the accrued interest as constructively received, in his federal income tax return for the year 1952, and paid the tax shown to be due thereon. Through error, he showed the receipt of \$6,000.00 as interest constructively received, whereas he should have reported \$12,000.00, since, as provided in the minutes of the petitioner corporation, the first payments to him were to be credited against interest, and not against accrued rental as the payments constructively received were reported in his return.

(k) In the taxable year 1953, the petitioner corporation paid interest to O. H. Kruse on its note for \$200,000.00, in the amount of \$12,000.00, which amount was reported as income by him, in his federal income tax return for that year.

(l) During the taxable years involved herein, 1952 and 1953, the petitioner leased certain real estate, which it regularly used in its business, from O. H. Kruse, for which it was obligated to pay an annual rental in the amount of \$12,000.00 per annum. Such rental payments were regularly accrued on the books of the petitioner corporation.

(m) The petitioner did not pay O. H. Kruse the rental due him for the taxable year 1952, in cash, although it was financially able to do so, for the reason that he preferred to leave the fund with the corporation, and, being in control of its affairs, was in a position, by reason of his control of the peti-



tioner corporation, to authorize, or to withhold its payment.

(n) The said O. H. Kruse, in his federal income tax return for 1952, reported the amount of \$18,000.00 as constructively received from the petitioner corporation in that year, on account of interest accrued on the petitioner's promissory note involved herein, computed at the rate of 6% per annum, and rental in the sum of \$6,000.00. Such payments were erroneously designated by him as the payment of interest to the extent of \$6,000.00, and rental income in the sum of \$12,000.00, whereas he should have shown the amount of \$12,000.00 as the receipt of interest, and \$6,000.00 as rental received, in accordance with the requirements contained in the petitioner corporation's minutes.

(o) In the taxable year 1953, payments in cash totalling the sum of \$14,000.00 were paid to O. H. Kruse by the petitioner, on account of accrued interest on the promissory note involved herein, and the payment of rent. As a result of a bookkeeping error, the amount of \$2,000.00 was entered on the books as a payment of interest on the said note, and \$12,000.00 as a payment of rental. In conformity with the instructions given in the minutes of the petitioner corporation, the payment of \$12,000.00 should have been recorded as a cash payment of interest, and \$2,000.00 as a cash payment of rental.

(p) The said O. H. Kruse, in his income tax return for the taxable year 1953, reported the receipt of interest on the promissory note issued by the petitioner which is involved herein, in the amount

of \$12,000.00, and rental income received from the petitioner in the sum of \$12,000.00, and paid the tax shown to be due thereon.

Wherefore, the petitioner prays that this Court may hear the proceeding and determine that there is no deficiency in federal income tax due from the petitioner for the taxable years 1952, or for the taxable year 1953.

[Seal] O. H. KRUSE GRAIN & MILLING,  
/s/ By O. H. KRUSE,  
President.

Duly Verified.

EXHIBIT "A"

U. S. Treasury Department  
Internal Revenue Service

Regional Commissioner  
1250 Subway Terminal Building  
417 South Hill Street  
Los Angeles 13, California

October 29, 1956

In replying refer to Ap:LA:AA-DRR 90-D:ICA.

O. H. Kruse Grain & Milling  
c/o Fray L. Hobson  
3750 West Sixth Street  
Los Angeles 5, California

Gentlemen:

You are advised that the determination of your income tax liability for the taxable years ended De-

Exhibit "A"—(Continued)

December 31, 1952 and December 31, 1953 discloses deficiencies in tax aggregating \$33,186.59, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, Rm. 1250, 417 South Hill St., Los Angeles, California. The signing and filing of this form will expedite the closing of your case by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after the re-

## Exhibit "A"—(Continued)

ceipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

RUSSELL C. HARRINGTON,  
Commissioner,

By H. L. DUCKER,  
Associate Chief, Appellate Division.

Enclosures: Statement, IRS Pub. No. 160, Agreement Form.

Ap:LA:AA-DRR  
90-D:ICA

## STATEMENT

O. H. Kruse Grain & Milling  
c/o Fray L. Hobson  
3750 West Sixth Street  
Los Angeles 5, California

Tax Liability for the Taxable Years Ended December 31, 1952 and December 31, 1953.

Year	Income Tax		
	Liability	Assessed	Deficiency
1952 .....	\$ 64,178.49	\$50,184.23	\$13,994.26
1953 .....	66,814.18	47,621.85	19,192.33
Totals .....	\$130,992.67	\$97,806.08	\$33,186.59

In making this determination of your income tax liability, careful consideration has been given to the report of examination forwarded to you April 23, 1956, to your protest dated June 6, 1956, and to the statements made at the conferences held July 6, August 6, and September 5, 1956.

A copy of this letter and statement has been mailed to your representative, Mr. Oliver R. Mills, 1093 Broxton Avenue, Los Angeles 24, California, in accordance with the authority contained in the power of attorney executed by you.

Exhibit "A"—(Continued)

Adjustments to Net Income

Taxable Year Ended December 31, 1952

Net income as disclosed by return .....	\$ 91,836.06
Unallowable deductions:	
(a) Interest expense disallowed .....	12,000.00
(b) Rent expense disallowed .....	12,000.00
	<hr/>
Net income adjusted .....	\$115,836.06

Explanation of Adjustments

(a) The deduction in the amount of \$12,000.00, which was claimed as interest expense on your return for each of the taxable years 1952 and 1953, is disallowed. It has been determined that no indebtedness exists within the meaning of section 23(b) of the Internal Revenue Code of 1939. It is further held that these amounts were not paid during the taxable years 1952 and 1953 or within two and one-half months following the close of the taxable years, pursuant to the provisions of section 24(c) of the Internal Revenue Code of 1939.

(b) The deduction in the amount of \$12,000.00, which was claimed as rental expense on your returns for each of the taxable years 1952 and 1953, is disallowed. These amounts were not paid during the taxable years 1952 and 1953 or within two and one-half months following the close of the taxable years, in accordance with the provisions of section 24(c) of the Internal Revenue Code of 1939.

Adjustments to Excess Profits Net Income

Taxable Year Ended December 31, 1952

Excess profits net income as disclosed by return .....	\$106,698.74
Additions:	
(a) Interest expense disallowed .....	\$12,000.00
(b) Rent expense disallowed .....	12,000.00      24,000.00
	<hr/>
Total .....	\$130,698.74
Deduction:	
(c) Adjustment for interest on borrowed capital ....	12,651.97
	<hr/>
Excess profits net income adjusted .....	\$118,046.77

## Exhibit "A"—(Continued)

Taxable Year Ended December 31, 1952—(Continued)

## Explanation of Adjustments

(a) and (b) These adjustments have been explained above.

(c) The adjustment for interest on borrowed capital is re-computed as follows:

Average daily borrowed capital in 1952 .....	\$ 60,110.73
Borrowed capital at beginning of first excess profits tax year—March 28, 1950 .....	8,000.00
	<hr/>
Increase .....	\$ 52,110.73
75% of increase .....	39,083.05
Ratio of 75% of increase to average daily borrowed capital in 1952 .....	65.02%
Interest paid on borrowed capital:	
Interest expense per return .....	\$14,862.68
Add: Interest income applied as offset .....	537.37
	<hr/>
Total interest expense .....	\$15,400.05
Less: Interest disallowed herein .....	12,000.00
	<hr/>
Interest paid on borrowed capital .....	\$ 3,400.05
Adjustment for interest on borrowed capital (65.02% of \$3,400.05) .....	\$ 2,210.71
Adjustment for interest on borrowed capital per return .....	14,862.68
	<hr/>
Decrease .....	\$ 12,651.97

## Income and Excess Profits Tax Computation

Taxable Year Ended December 31, 1952

## Income Tax

Net income .....	\$115,836.06
Combined normal tax and surtax (52% less \$5,500.00) .....	54,734.75

## Excess Profits Tax

Excess profits net income .....	\$118,046.77
Excess profits credit, Exhibit A .....	81,897.56
	<hr/>

Adjusted excess profits net income .....	\$ 36,149.21
30% of adjusted excess profits net income .....	\$ 10,844.76
18% of excess profits net income .....	\$ 21,248.42

Exhibit "A"—(Continued)

Income and Excess Profits Tax Computation—(Continued)

Taxable Year Ended December 31, 1952—(Continued)

New corporation—3rd year	
(8% of excess profits net income) .....	\$ 9,443.74
Excess profits tax (smallest of above amounts) .....	\$ 9,443.74
Income tax .....	54,734.75
	<hr/>
Total tax liability .....	\$ 64,178.49
Total tax previously assessed, Account	
No. CI 862 Los Angeles District .....	50,184.23
	<hr/>
Deficiency .....	\$ 13,994.26

Adjustments to Income

Taxable Year Ended December 31, 1953

Net income as disclosed by return .....	\$ 93,701.73
Unallowable deductions:	
(a) Interest expense disallowed .....	12,000.00
(b) Rent expense disallowed .....	12,000.00
	<hr/>
Net income adjusted .....	\$117,701.73

Explanation of Adjustments

(a) and (b) These adjustments have previously been explained above.

Adjustments to Excess Profits Net Income

Taxable Year Ended December 31, 1953

Excess profits net income as disclosed by return .....	\$104,878.33
Additions:	
(a) Interest expense disallowed .....	\$12,000.00
(b) Rent expense disallowed .....	12,000.00      24,000.00
	<hr/>
Total .....	\$128,878.33
Deduction:	
(c) Adjustment for interest on borrowed capital ....	11,140.89
	<hr/>
Excess profits net income adjusted .....	\$117,737.44

## Exhibit "A"—(Continued)

Taxable Year Ended December 31, 1953—(Continued)

## Explanation of Adjustments

(a) and (b) These adjustments have previously been explained above.

(c) The adjustment for interest on borrowed capital is recomputed as follows:

Average daily borrowed capital in 1953 .....	\$ 10,000.00
Borrowed capital at beginning of first excess profits tax year—March 28, 1950 .....	8,000.00
	<hr/>
Increase .....	\$ 2,000.00
75% of increase .....	1,500.00
Ratio of 75% of increase to average daily borrowed capital in 1953 .....	15.0%
Interest paid on borrowed capital .....	\$ 238.07
Adjustment for interest on borrowed capital (15.0% of \$238.07) .....	\$ 35.71
Adjustment for interest on borrowed capital per return .....	11,176.60
	<hr/>
Decrease .....	\$ 11,140.89

## Income and Excess Profits Tax Computation

Taxable Year Ended December 31, 1953

## Income Tax

Net income .....	\$117,701.73
Combined normal tax and surtax (52% less \$5,500.00) .....	\$ 55,704.90

## Excess Profits Tax

Excess profits net income .....	\$117,737.44
Excess profits credit, Exhibit A .....	80,706.50

Adjusted excess profits net income .....	\$ 37,030.94
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30% of adjusted excess profits net income .....	\$ 11,109.28
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18% of excess profits net income .....	\$ 21,192.74
--	--------------

New corporation—4th year

(11% of excess profits net income) .....	\$ 12,951.12
--	--------------

Excess profits tax (smallest of above amounts) .....	\$ 11,109.28
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Income tax .....	55,704.90
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Total tax liability .....	\$ 66,814.18
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Total tax previously assessed, Account No. CI 395,

Los Angeles District .....	47,621.85
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Deficiency .....	\$ 19,192.33
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Exhibit "A"—(Continued)

Exhibit "A"

EXCESS PROFITS CREDIT—BASED ON INCOME

Taxable Years Ended December 31, 1952 and December 31, 1953.

Average Base Period Net Income—Based on Growth:

1. Date of commencement of business	1935	
	Total Payroll	Gross Receipts
2. (a) Last half of base period .....	\$184,485.50	\$3,668,022.12
(b) First half of base period .....	\$138,834.14	\$2,779,488.97
(c) Percentage which (a) is of (b)	133%	132%
3. Excess profits net income for last 24 months of base period .....	\$	90,384.16
4. One-half of line 3 .....	\$	45,192.08
5. Excess profits net income for last 12 months of base period .....	\$	47,271.15
6. Weighted excess profits net income for first 6 months of 1950 .....	\$	57,104.16
7. Excess profits net income for last 6 months of 1949 .....	\$	23,635.56
8. Line 6 plus line 7 .....	\$	80,739.72
9. Average base period net income based on growth (highest of lines 4, 5 or 8) .....	\$	80,739.72
Excess Profits Credit:	1952	1953
10. Line 9 x 83% .....	\$67,013.97	\$67,013.97
11. 12% of net capital addition, Exhibit B	14,883.59	13,692.53
12. Excess profits credit based on income	\$81,897.56	\$80,706.50

## Exhibit "A"—(Continued)

## Exhibit "B"

## TAXABLE YEAR CAPITAL ADDITIONS

Taxable Years 1952 and 1953

	1952	1953
1. Equity capital beginning of first taxable year ending after June 30, 1950 per Exhibit C .....	\$280,000.00	\$280,000.00
2. Equity capital beginning of taxable year, Exhibit C .....	\$364,946.83	\$392,604.40
3. Borrowed capital at beginning of first taxable year ending after June 30, 1950 .....	\$ 8,000.00	\$ 8,000.00
4. Average daily amount of borrowed capital for taxable year .....	\$ 60,110.73	\$ 10,000.00
5. Line 2 minus line 1 .....	\$ 84,946.83	\$112,604.40
6. 75% of line 4 minus line 3 .....	39,083.05	1,500.00
7. Average daily capital addition (line 5 plus line 6) .....	\$124,029.88	\$114,104.40
8. Average daily capital reduction .....	0.00	0.00
9. Net capital addition .....	\$124,029.88	\$114,104.40
10. 12% of net capital addition .....	\$ 14,883.59	13,692.53

## Exhibit "C"

## EQUITY CAPITAL AT BEGINNING OF YEAR

Taxable Years 1950, 1952 &amp; 1953

Assets at April 1, 1950:

Cash .....	\$ 45,618.63	
Accounts Receivable .....	139,506.62	
Merchandise Inventory .....	37,724.59	
Office Equipment .....	1,450.71	
Autos and Trucks .....	33,877.56	
Machinery and Equipment .....	43,736.26	
Prepaid Insurance .....	4,163.67	
Insurance Deposits .....	2,293.48	\$308,371.52

Exhibit "A"—(Continued)

Equity Capital At Beginning of Year—(Continued)

Taxable Years 1950, 1952 & 1953—(Continued)

Liabilities:

Notes Payable (Bank) .....	\$ 8,000.00	
Accounts Payable .....	1,710.00	
Accrued Payroll Taxes .....	82.23	
Accounts Payable—Officer .....	18,579.29	28,371.52
	<hr/>	<hr/>
Equity capital at April 1, 1950 .....		\$280,000.00
Assets per books at January 1, 1952 .....	\$494,348.74	
Add: Incorporation costs .....	401.09	\$494,749.83
	<hr/>	<hr/>
Liabilities per books .....	\$325,472.20	
Add: California Franchise tax (1950) ..	380.04	
Federal income tax deficiency (1950) ..	3,950.76	
	<hr/>	<hr/>
Total .....	\$329,803.00	
Less: Note of O. H. Kruse .....	200,000.00	129,803.00
	<hr/>	<hr/>
Equity capital at January 1, 1952 .....		\$364,946.83
		<hr/> <hr/>
Assets per books at January 1, 1953 .....	\$549,277.45	
Add: Incorporation costs .....	401.09	\$549,678.54
	<hr/>	<hr/>
Liabilities per books .....	\$338,749.08	
Add: California Franchise tax (1950) ..	380.04	
Federal Income tax deficiency (1950) ..	3,950.76	
Federal income tax deficiency (1952) ..	13,994.26	
	<hr/>	<hr/>
Total .....	\$357,074.14	
Less: Note of O. H. Kruse .....	200,000.00	157,074.14
	<hr/>	<hr/>
Equity capital at January 1, 1953 .....		\$392,604.40
		<hr/> <hr/>

Served and Entered: February 4, 1957.

[Endorsed]: T.C.U.S. Filed January 28, 1957.

[Title of Tax Court and Cause.]

### ANSWER

The Commissioner of Internal Revenue, by his attorney, Nelson P. Rose, Chief Counsel, Internal Revenue Service, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1, 2, and 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4. Denies the allegations of error contained in paragraph 4 of the petition.

5. (a) With regard to the facts upon which the petitioner relies as the basis of this proceeding, admits the allegations contained in subparagraph (a) on Page 3 of paragraph 5 of the petition.

(b) Denies, for lack of sufficient information presently available, the allegations contained in subparagraph (b) on Page 3 of paragraph 5 of the petition.

(a) Admits that the said O. H. Kruse transferred his business, and substantially all of the assets employed therein, subject to its then liabilities, to a corporation organized by him under the laws of the State of California, with the name "O. H. Kruse Grain & Milling," the petitioner herein; denies the remaining allegation contained in subparagraph (a) on Page 5 of paragraph 5 of the petition.

(b) Denies the allegations contained in subparagraph (b) on Page 5 of paragraph 5 of the petition.

(c) through (k) Denies the allegations contained in subparagraphs (c) through (k) of paragraph 5 of the petition.

(l) Admits the allegations contained in subparagraph 1 of paragraph 5 of the petition.

(m) through (o) Denies the allegations contained in subparagraphs (m) through (o) of paragraph 5 of the petition.

(p) Admits the allegations contained in subparagraph (p) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ NELSON P. ROSE, REM,  
Chief Counsel, Internal  
Revenue Service.

Of Counsel: Melvin L. Sears, Regional Counsel,  
E. C. Crouter, Assistant Regional Counsel,  
R. E. Maiden, Jr., Special Assistant to the Regional Counsel, Joseph G. White, Jr., Attorney.

Served and Entered March 19, 1957.

[Endorsed]: T.C.U.S. Filed March 18, 1957.

[Title of Tax Court and Cause.]

### STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. The petitioner is a corporation organized under the laws of the State of California on March 27, 1950.

2. The petitioner corporation had an authorized capital stock of \$300,000.00, consisting of 3,000 shares, each of the par value of \$100.00.

3. O. H. Kruse, president of the petitioner corporation, had been engaged in the hay, grain, and feed business for a period of fourteen years, immediately prior to the organization of the petitioner corporation.

4. The name under which O. H. Kruse conducted his business as a sole proprietorship was O. H. Kruse Grain and Milling.

5. The assets of O. H. Kruse which were transferred to the petitioner corporation in exchange for stock consisted of the following:

Office Equipment .....	\$ 1,865.76	
Autos and Trucks .....	57,135.27	
Machinery and Equipment .....	64,113.91	
		<hr/>
	\$123,114.94	
Less accrued depreciation .....	44,050.41	
		<hr/>
		\$ 79,064.53
Prepaid insurance .....	4,163.67	
Insurance deposits less accrued premiums .....	2,293.48	
Cash .....	4,270.55	
		<hr/>
		\$89,792.23

6. The liabilities of O. H. Kruse which were assumed by the petitioner corporation were as follows:

Notes Payable (bank).....	\$8,000.00
Accounts Payable (trade)....	1,710.00
Accrued payroll taxes	
(due 12/31/50) .....	82.23
	<hr/>
	\$9,792.23

7. O. H. Kruse conveyed the following assets to the petitioner corporation and accepted in payment therefor its promissory note in the principal sum of \$200,000.00, and an open account in his favor, in the amount of \$18,579.29:

Accounts Receivable .....	\$139,506.62
Merchandise Inventory ....	37,724.59
Cash .....	41,348.08
	<hr/>
	\$218,579.29

8. Payment of the petitioner corporation's note was made in installments as follows:

November 1, 1955.....	\$100,000.00
April 12, 1957.....	20,000.00
October 22, 1958.....	80,000.00
	<hr/>
	\$200,000.00

/s/ LeVONE A. YARDUM,  
Counsel for Petitioner.

/s/ ARCH M. CANTRALL, REM,  
Chief Counsel, Internal Revenue Service, Counsel  
for Respondent.

[Endorsed]: T.C.U.S. Filed January 8, 1959.

—————  
T. C. Memo. 1959-110

Tax Court of the United States

O. H. Kruse Grain & Milling, Petitioner, v. Com-  
missioner of Internal Revenue, Respondent.

Docket No. 65683. Filed May 26, 1959.

MEMORANDUM FINDINGS OF FACT  
AND OPINION

Held, that the petitioner, in giving a promissory note to its majority stockholder, did not intend to create a true indebtedness within the meaning of section 23 (b) of the Internal Revenue Code of 1939



and consequently is not entitled to deductions for interest on such note for the years 1952 and 1953.

Held, further, that rental payments to its majority stockholder which were accrued by petitioner on its books for the years 1952 and 1953 were includable in the gross income of the payee by application of the doctrine of constructive receipt and the claimed deductions are not barred by section 24 (c), I.R.C. of 1939.

LeVone A. Yardum, Esq., for the petitioner.

John E. Schessler, Esq., and J. Earl Gardner, Esq., for the respondent.

Mulroney, Judge: The respondent determined deficiencies in the income tax of petitioner for the years 1952 and 1953 in the respective amounts of \$13,994.26 and \$19,192.33.

The questions in the case are:

1. Whether an alleged promissory note issued in 1950 by petitioner to O. H. Kruse, who, with his wife jointly owned all of the petitioner's outstanding stock, was a true indebtedness so that accrued interest thereon during the years 1952 and 1953 would be deductible under the provisions of section 23 (b), Internal Revenue Code of 1939;<sup>1</sup> and

2. Whether petitioner is barred by section 24 (c) from deducting accrued rental expense during the years 1952 and 1953.

---

<sup>1</sup> All section references are to the Internal Revenue Code of 1939, as amended.

## Findings of Fact

Some of the facts were stipulated and they are found accordingly.

Petitioner is a corporation organized under the laws of the State of California and it filed its corporate income tax returns for the years 1952 and 1953 with the district director of internal revenue at Los Angeles, California.

O. H. Kruse, sometimes referred to in the record as Otto H. Kruse, president of petitioner corporation, had been engaged in the hay, grain and feed business for a period of 14 years prior to 1950. In April 1950 O. H. Kruse and his wife, Helen D. Kruse, formed petitioner corporation, using the name O. H. Kruse Grain & Milling as the name of the corporation, which was the same name as O. H. Kruse had used in conducting his business as a sole proprietorship. The petitioner corporation had an authorized capital stock of \$300,000, consisting of 3,000 shares of \$100 par value each. On April 1, 1950, O. H. Kruse transferred to petitioner, in exchange for 800 shares of stock, the following property:

Office Equipment .....	\$ 1,865.76	
Autos and Trucks .....	57,135.27	
Machinery and Equipment .....	64,113.91	
		<hr/>
	\$123,114.94	
Less accrued depreciation .....	44,050.41	
		<hr/>
		\$ 79,064.53
Prepaid insurance .....	4,163.67	
Insurance deposits less accrued premiums .....	2,293.48	
Cash .....	4,270.55	
		<hr/>
		\$89,792.23

In this transaction petitioner assumed liabilities of O. H. Kruse, as follows:

Notes payable (bank) . . . . .	\$8,000.00
Accounts payable (trade) . . . .	1,710.00
Accrued payroll taxes (due 12/31/50) . . . . .	82.23
	<hr/>
	\$9,792.23

The minutes of the meeting of June 15, 1950 of the board of directors of the petitioner corporation show the following:

Mr. Kruse then stated that he had advanced funds to the corporation for working capital, and that he would be willing to accept the corporation's promissory note for \$200,000.00 payable December 31, 1950, to bear interest at the rate of 6% per annum beginning January 1, 1951, if the note should be unpaid on that date. The balance of the advance could be carried as an open account. Payments to Mr. Kruse, other than those on the promissory note, should be applied first to accrued interest, secondly to accrued rental, and then to the open account.

The following resolution is also contained in these minutes:

Resolved: That the officers of the corporation be directed to execute a promissory note in the amount of \$200,000.00, payable to Mr. O. H. Kruse, payable on December 31, 1950, and to

bear interest at the rate of 6% per annum if unpaid on January 1, 1951.

O. H. Kruse conveyed the following assets to the petitioner corporation and accepted in payment therefor its promissory note in the principal sum of \$200,000 and an open account in his favor in the amount of \$18,579.29:

Accounts receivable . . . . .	\$139,506.62
Merchandise inventory . . . . .	37,724.59
Cash . . . . .	41,348.08
	<hr/>
	\$218,579.29

The \$200,000 note was dated June 15, 1950 and it provides for the payment of the \$200,000 "On or before December 31, 1950 or thereafter on demand" and it bears interest at the rate of 6 per cent "from January 1, 1951 until paid, interest payable semi-annually."

Petitioner rented certain real estate consisting of mills and a small house used as an office from O. H. Kruse for \$1,000 per month and continued renting this property through the year 1953. The corporate journal entry for each month of 1952 and 1953 shows a debit to "Interest" or "Interest Expense" and a credit to "Accrued Interest." These monthly journal entries were posted to ledger sheets entitled "Accrued Interest."

The corporate journal entry for each month for 1952 and 1953 shows a debit to "Rent" or "Rental Expense" and a credit to "Accrued Rent." These

monthly journal entries were posted to ledger sheets entitled "Accrued Rent." Petitioner had a line of credit of \$100,000 with the Bank of America established on November 3, 1951 and on said date O. H. Kruse and Helen D. Kruse signed a subordination agreement subordinating the \$200,000 note obligation to any existing loan with the bank. In said agreement O. H. Kruse and his wife agreed not to sue, collect or receive payment upon any claim, nor interest thereon, which they held against petitioner so long as petitioner owed the bank.

Petitioner corporation deducted accrued interest of \$9,000 and accrued rent of \$9,000, both payable to O. H. Kruse, in 1950.

Petitioner corporation deducted \$12,000 rent and \$12,000 interest both payable to O. H. Kruse, and O. H. Kruse, who reported his income on the cash method of accounting at all times, reported \$21,000 rent and no interest from petitioner corporation in 1951. Nothing was paid on these items in 1951.

Petitioner corporation deducted accrued rent of \$12,000 and accrued interest of \$12,000 both owing to O. H. Kruse in 1952. O. H. Kruse reported \$12,000 rent and \$6,000 interest both from petitioner in 1952. Nothing was paid on these items in 1952.

Petitioner corporation deducted accrued rent of \$12,000 and accrued interest of \$12,000 both owing to O. H. Kruse in 1953. O. H. Kruse reported \$12,000 rent and \$12,000 interest, both from petitioner in 1953.

Petitioner paid \$2,000 interest in September 1953 and \$12,000 rent in December 1953 to O. H. Kruse. Payment of the corporation's note to O. H. Kruse was made in installments as follows:

November 1, 1955.....	\$100,000
April 12, 1957.....	20,000
October 22, 1958.....	80,000
	\$200,000

Respondent disallowed petitioner's deductions in the amount of \$12,000 for each of the years 1952 and 1953 as interest expense on the ground that no indebtedness existed within the meaning of section 23 (b) of the Internal Revenue Code of 1939 and also on the ground that these amounts were not paid during the taxable years 1952 and 1953 or within 2½ months following the close of the taxable years, pursuant to the provisions of section 24 (c) of the Internal Revenue Code of 1939.

Respondent also disallowed deductions in the amount of \$12,000 in each of the years 1952 and 1953 as rental expense on the ground that these amounts were not paid during the taxable years 1952 and 1953 or within 2½ months following the close of the taxable years, pursuant to the provisions of section 24 (c) of the Internal Revenue Code of 1939.

Petitioner's note of June 15, 1950, payable to Otto H. Kruse in the sum of \$200,000, was not a bona fide indebtedness of petitioner and interest accrued thereon in 1952 and 1953 was not deductible.

Petitioner was not precluded by section 24 (c) from deducting accrued rental expense in the sum of \$12,000 for each of the years 1952 and 1953.

### Opinion

In disallowing petitioner's deductions of interest expense in the sum of \$12,000 for each of the years 1952 and 1953, respondent explained that his disallowance was based on his determination "that no indebtedness exists within the meaning of section 23 (b) of the Internal Revenue Code of 1939." Since the usual presumption of correctness, inhering in respondent's determination, applies, the burden was on petitioner to establish the existence of the indebtedness to which the claimed interest expense was related. Petitioner sought to sustain its burden by introducing the \$200,000 note given to its president, who, with his wife jointly, held all of its stock, the minutes of the corporation, the books of the corporation which might be said to show accruals of interest on this note and \$2,000 payment of such interest in 1953, and almost nothing more which would tend to substantiate the interest deduction.

The significant fact is that petitioner sought to establish its burden without the testimony of O. H. Kruse and there is no explanation in the record that his testimony was unavailable. The only witness in the case was Fray L. Hobson, a certified public accountant who described himself as an assistant secretary of petitioner, but actually petitioner was merely one of the clients of his accountancy busi-

ness, for whom he worked as an accountant about three days a month.

The record in this case shows that in 1950 O. H. Kruse, desiring to incorporate his grain and milling business that he had operated for 14 years as a sole proprietorship, formed a corporation with the same name as his sole proprietorship business, to which corporation he first transferred part of his business assets and received payment therefor in the form of 800 shares of stock, and to which he later transferred other business assets such as accounts receivable, stock of merchandise, and some cash in the sum of \$41,348.08 and received in payment therefor the corporation's note in the sum of \$200,000 and an \$18,579.29 open account in his favor. The 800 shares of stock, which were issued to O. H. Kruse and his wife, jointly, were all of the issued shares and O. H. Kruse became the president of the corporation and in complete control at the time the \$200,000 note was issued by the corporation to him. The question is whether the \$200,000 note did, in reality, represent a bona fide indebtedness of the corporation or whether it was a contribution to capital. There have been many cases involving the issue of whether the principal stockholder of a closely held corporation succeeded in establishing a creditor-debtor relationship between himself and the corporation. See *Gooding Amusement Co.*, 23 T.C. 408, and the affirming opinion in *Gooding Amusement Co. v. Commissioner*, 236 F. 2d 159, where many cases involving this issue are cited and reviewed. The issue is essentially one of fact (*Tribune*



Publishing Co., 17 T.C. 1228) and it is to be decided upon the facts and circumstances of the particular case (Charles L. Huisking & Co., 4 T.C. 595). Various factors and combination of factors have been relied upon in the decided cases as a basis for the determination of the issue. The inquiry is not limited to the instruments, and it has been said the real intent of the parties is the decisive factor. Gooding Amusement Co., *supra*; Proctor Shop, Inc., 30 B.T.A. 721.

One of the factors is the presence or absence of a fixed maturity date for the instrument, Mullin Building Corporation, 9 T.C. 350. Here the \$200,000 note dated June 15, 1950 and executed by O. H. Kruse as president of the corporation in favor of himself was on the usual printed note form but in the written part it provided for payment "On or before December 31, 1950 or thereafter on demand." It appears to be a demand note with no right to make demand for about the first six months and the right to fix the maturity date by demand after December 31, 1950, given to the payee. We need not say that in all cases a demand note given to a stockholder would not evidence an indebtedness, but we think it can be said here as was said of the obligation in Gooding Amusement Co., *supra*:

The husband held the majority stock in the corporation. It is, in our opinion, unreasonable to ascribe to the husband petitioner, F. E. Gooding, an intention at the time of the issuance of the notes ever to enforce payment of his notes, especially if to do so would either impair

the credit rating of the corporation,<sup>5</sup> cause it to borrow from other sources the funds necessary to meet the payments, or bring about its dissolution. \* \* \* [Footnote omitted.]

This points up the failure of O. H. Kruse to testify, for the unexplained terms of the note instrument leaves a permissible inference that O. H. Kruse, at the time he had his corporation issue the note to him, did not intend to enforce payment by his corporation if by so doing his corporation would be at all inconvenienced. This inference is somewhat strengthened by the subordination agreement executed by O. H. Kruse and his wife in November 1951 with the Bank of America at the time the corporation established a \$100,000 line of credit with the bank. The said agreement subordinated the corporation's obligation on the note to the corporation's indebtedness to the bank and O. H. Kruse therein promised to do nothing toward collection or enforcement of the obligation of the note "nor interest thereon" as long as the corporation was indebted to the bank.

It is also of interest to note the treatment accorded the obligation of the note and especially the interest obligation by O. H. Kruse and also by the corporation. In 1950 the corporation accrued \$9,000 interest on this note obligation and took a deduction therefor although the note by its terms did not provide for any interest until January 1, 1951. Hobson, who either kept the books or supervised the book-keeping, and who made out the corporation's return merely stated this was a mistake: "When the 1950

return was reviewed, that error was corrected.” Hobson also said he made out Kruse’s 1950 income tax return but for some reason neither the original nor copy of this return was made available so we do not know how O. H. Kruse treated the \$9,000 interest item in that return. We do know that in 1951 the corporation accrued \$12,000 interest on the note and took deduction therefor on the return prepared by Hobson, and O. H. Kruse in his return for that year reported the receipt of no interest. Hobson testified he made out Kruse’s return and this was another “mistake.” His name does not appear on this return as the person who prepared it. Again in 1952 the corporation accrued \$12,000 interest on the note and took deduction therefor in the 1952 return made out by Hobson. In O. H. Kruse’s return for that year he only reported receipt of \$6,000 interest on the note. Again Hobson states this was a mistake. This return bears Hobson’s signature as the person who prepared it but underneath there is typed: “Prepared from data submitted by taxpayer.” In the 1953 return of the corporation and O. H. Kruse, both prepared by Hobson, there is the deduction of \$12,000 interest on the corporation return and the report of receipt of \$12,000 interest on the O. H. Kruse return.

There is some question as to the sufficiency of the book entries to show interest accruals but we will assume Hobson, the certified public accountant, was at least correct, since 1951, in showing the interest accruals. It is no explanation for Kruse’s and the corporation’s accountant merely to say there were

“mistakes” in the books and corporation income tax return for 1950, and in Kruse’s income tax returns for the years 1950, 1951 and 1952. All of these so-called mistakes relate directly to the alleged interest obligation which was the subject of deduction by the corporation in the years in question. It is obvious the treatment of the interest obligation in these early years must be termed a mistake if petitioner is to argue the note presents an unconditional and legally enforceable obligation for the payment of \$200,000. But this treatment of the interest obligation, standing unexplained by O. H. Kruse, is some evidence that casts doubt as to there being an intention to issue a legally enforceable obligation. There are other bits of evidence that also cast doubt upon there being an intention to create a real debt when O. H. Kruse caused the corporation he controlled to issue the note to him. The note was unsecured. Although the corporation paid its obligations, other than this note, promptly, it made no payment on the principal on this note until November 1955, which was after the issue as to whether this was a true corporate obligation had been raised by the revenue agent.

Upon the whole record we hold petitioner failed to sustain its burden of proving the existence of an indebtedness to which the interest expense related.

Respondent makes an alternative argument with respect to the interest deductions for 1952 and 1953 to the effect that the corporation is barred by section 24 (c) from deducting interest it accrued which was not actually paid to or includible in the gross

income of O. H. Kruse within the taxable year that the deduction was taken or 2½ months following the close thereof. Because of our holding that the interest deductions were properly disallowed because no genuine indebtedness existed, we need not consider this portion of respondent's argument. But respondent makes a similar argument based on his determination with respect to \$12,000 rental deduction petitioner took in 1952 and the \$12,000 rental deduction petitioner took in 1953, which deduction respondent also disallowed.

The minutes of the corporation show the rental by the corporation, on a year to year basis, of all of the real property it occupied, which was owned by O. H. Kruse, consisting of two mills and a small house used for an office at a rental of \$1,000 a month. No question is raised as to the amount of the rental being reasonable and the corporation accrued the \$1,000 rental item each month. The rent of \$12,000 for 1952 was not actually paid in that year to O. H. Kruse nor was it paid to him within 2½ months thereafter. The books of the corporation show the issuance of a check to O. H. Kruse dated December 15, 1953 in the sum of \$12,000 which Hobson identifies as being for rent. Respondent does not seem to question this evidence as being sufficient to establish petitioner's payment of the \$12,000 rent deducted in its 1953 return. The question is whether the evidence is sufficient to show constructive receipt by O. H. Kruse of as much rent as the corporation deducted for the year 1952.

Petitioner argues the \$12,000 yearly rental during the years involved was “constructively received” by O. H. Kruse—that under the doctrine of constructive receipt the \$12,000 rental was includible in the gross income of O. H. Kruse. The record shows that O. H. Kruse did include the \$12,000 rental as income in his return for all of the years, including the years in question. In his return for 1951 O. H. Kruse reported \$21,000 rental income from the corporation for this property which Hobson explains as another one of his “mistakes.”

The issue turns upon whether the rental income was set apart or credited to O. H. Kruse so that it could be drawn upon by him without any substantial limitation. *Geiger & Peters, Inc.*, 27 T.C. 911. The record is not too clear but the journal entry each month shows a debit to “Rent” or “Rental Expense” and credit to “Accrued Rent.” These journal entries were posted in the ledger sheets of the corporation entitled “Accrued Rent.” Hobson, who set up the books, testified he did not think it necessary that the accrued rent account be further identified in the books as an obligation owed to O. H. Kruse because this was the property the corporation occupied, and it was identified in the minutes as being Kruse’s property that the corporation was renting and it was the only property it rented and he and O. H. Kruse knew exactly to whom the rental account was owed. It is true that there is not the same need for a multiplicity of accounts or identity of accounts in a small wholly owned corporation, such as would be required completely to inform officers,

directors, and stockholders of a corporation with many stockholders. It fairly appears from the books that the rent accrued during the years in question was the rent due to O. H. Kruse of \$1,000 a month for the property petitioner occupied. We also hold this rent was constructively received by O. H. Kruse in 1952. When we treat the accrued rent account in the ledger as being an accrued obligation owing to O. H. Kruse, who was, in effect, in sole control of the corporation, it must be admitted the accruals were subject to his "unqualified demand." *Platt Trailer Co.*, 23 T.C. 1065. Without delving deeply into the corporate finances, it is clear the corporation could have paid the rental obligation in 1952, either out of cash, or from borrowing on its unused line of credit in the Bank of America, or by a secured loan pledging some \$300,000 in accounts receivable. We have earlier held the rental for 1953 was paid. We hold petitioner was entitled to the rental deductions in the sum of \$12,000 for each of the years 1952 and 1953.

Decision will be entered under Rule 50.

Served May 26, 1959.

*O. H. Kruse Grain & Milling vs.*

Tax Court of the United States  
Washington

Docket No. 65683

O. H. KRUSE GRAIN & MILLING,  
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

### DECISION

Pursuant to the Court's Memorandum Findings of Fact and Opinion, filed May 26, 1959, the parties herein having filed an agreed computation of tax on August 4, 1959, it is

Ordered and Decided: That there are deficiencies in income tax for the taxable years 1952 and 1953 in the respective amounts of \$5,555.28 and \$9,048.53.

[Seal]     /s/ JOHN E. MULRONEY,  
                    Judge.

Entered August 7, 1959.

Served August 10, 1959.



In the United States Court of Appeals  
For the Ninth Circuit

T. C. Docket No. 65683

O. H. KRUSE GRAIN & MILLING, a corpora-  
tion, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

### PETITION FOR REVIEW

O. H. Kruse Grain & Milling, a corporation, the petitioner in this cause, by LeVone A. Yardum, counsel, hereby files its petition for a review by the United States Court of Appeals for the Ninth Circuit of the decision by The Tax Court of the United States on August 7, 1959, T. C. Memo, 1959-110, determining deficiencies in the petitioner's Federal income taxes for the calendar years 1952 and 1953, in the respective amounts of \$5,555.28 and \$9,048.53, and respectfully shows:

#### I.

The petitioner, O. H. Kruse Grain & Milling, is a corporation duly organized and existing under and by virtue of the laws of the State of California, with its principal office at 1459 North Tyler Street, El Monte, California.

The tax returns for the years involved herein were filed with the District Director of Internal Revenue for the Sixth District California.

The principal place of business of the petitioner corporation, O. H. Kruse Grain & Milling, is within the jurisdiction of the United States District Court and United States Tax Court for the Southern District of California and within the jurisdiction of the Ninth Circuit of the United States Court of Appeals.

That the trial of the above matter in the Tax Court of the United States was tried in the Tax Court located in the Federal Building, Los Angeles, California.

## II.

### Nature of the Controversy

The controversy involves the proper determination of the petitioner's liability for federal income taxes for the calendar years 1952 and 1953.

In the year 1950, O. H. Kruse, an individual, transferred certain depreciable assets which had been used by him in the business conducted as a sole proprietorship, at their depreciated cost; prepaid expense items, and some cash totalling \$89,792.23, subject to liabilities of \$9,792.23, in exchange for eight hundred (800) shares of the capital stock of O. H. Kruse Grain & Milling, a corporation, the petitioner herein.

The said O. H. Kruse also transferred accounts receivable and the inventory of the business previously conducted by him in the amounts of \$139,506.62, and \$37,724.59, respectively, together with cash in the sum of \$41,348.00, to the petitioner in exchange for its promissory note in the principal

amount of \$200,000.00, and an open account receivable of \$18,579.29.

In addition, he transferred to the petitioner intangible assets consisting of contracts, good will, etc., with a value of \$208,973.00, for no consideration.

The promissory note issued by the petitioner to O. H. Kruse, in the principal amount of \$200,000.00 was declared to be due "on or before December 31, 1950, or thereafter on demand." If not paid by January 1, 1951, interest became payable thereon at the rate of 6% per annum, semi-annually.

At a meeting of the Board of Directors of the petitioner, held on June 15, 1950, a resolution was adopted providing that payments to O. H. Kruse, other than those on the promissory note, should be applied first to accrued interest, secondly to accrued rental, and then to the open account.

The petitioner keeps its books and records on the accrual basis.

Interest on the note in question was accrued on the books of the petitioner, in the amount of \$12,000.00, for each of the years 1952 and 1953.

Said note was paid in installments by the petitioner corporation to said O. H. Kruse, as follows:

November 1, 1955.....	\$100,000.00
April 12, 1957.....	20,000.00
October 22, 1958.....	80,000.00
	<hr/>
Total .....	\$200,000.00

In its Federal income tax returns for each of the years 1952 and 1953, the petitioner deducted as an expense of doing business, the amount of interest accrued on its promissory note which was \$12,000.00.

The Commissioner of Internal Revenue held that the said promissory note was not a bona fide obligation of the petitioner corporation and disallowed the deduction claimed for interest accrued thereon (\$12,000.00) in each of the years 1952 and 1953, and determined the deficiencies for the years 1952 and 1953, as aforesaid.

The trial court, Tax Court of the United States, held that the petitioner corporation, in giving its promissory note to its majority stockholder, did not intend to create a true indebtedness within the meaning of Section 23(b) of the Internal Revenue Code of 1939 and consequently that the petitioner corporation was not entitled to deductions for interests on such note for the years 1952 and 1953.

Petitioner does not appeal from that portion of the findings and opinion of the Court which held that the rental payments to the corporation's majority stockholder which were accrued by the petitioner corporation on its books for the years 1952 and 1953 were includible in the gross income of the payee, O. H. Kruse, by application of the doctrine of constructive receipt, and that the claimed deductions made by the corporation were not barred by Section 24(e), Internal Revenue Code of 1939.

The said O. H. Kruse Grain & Milling, being

aggrieved by the findings of fact and conclusions of law contained in said findings and opinion of the Court, and by its decision pursuant thereto, desires to obtain a review thereof by the United States Court of Appeals for the Ninth Circuit.

/s/ LeVONE A. YARDUM,  
Counsel for Petitioner.

Duly Verified.

Affidavit of Service by Mail Attached.

[Endorsed]: T.C.U.S. Filed September 14, 1959.

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In The Tax Court of the United States

Docket No. 65683

O. H. KRUSE GRAIN AND MILLING,  
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

### TRANSCRIPT OF PROCEEDINGS

Courtroom No. 9, Federal Building, Los Angeles, California, Thursday, January 8, 1959.

The above-entitled matter came on for hearing, pursuant to notice to the parties, at 10:00 o'clock, a.m.

Before: Honorable *James E. Mulroney*, Presiding.

Appearances: *LeVone A. Yardum*, Esq., 9405 Brighton Way, Beverly Hills, California, for *O. H. Kruse Grain and Milling*, Petitioner. *John Schessler*, Esq., and *J. Earl Gardner*, Esq., Room 1135, Subway Terminal Building, 417 South Hill Street, Los Angeles, California, for the Respondent. [1]\*

### Proceedings

The Clerk: Docket No. 65683, *O. H. Kruse Grain and Milling*.

Gentlemen, will you state your appearances for the record?

Mr. Yardum: *LeVone A. Yardum* for the petitioner.

Mr. Schessler: *John Schessler* and *J. Earl Gardner* for the respondent.

The Court: How long will this case take, gentlemen?

Mr. Yardum: We will estimate it, we originally estimated it two hours, your Honor.

It may take a little longer.

We can probably finish it this morning, your Honor. I think so.

The Court: Or early afternoon?

Mr. Yardum: We are in the process of signing a stipulation that should shorten it. I haven't signed it yet.

Are we going to go on first, your Honor?

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\* Page numbers appearing at top of page of Reporter's Transcript of Record.

The Court: Well, I think so. I thought we might go on with this case and dispose of this case this morning.

We will go on with the O. H. Kruse case.

I assume that before the case is submitted, you will be able to sign the stipulation?

Mr. Yardum: If I just take a few minutes now, I [4] can read it.

The Court: Very well. We will take a short recess.

(Short recess taken.)

The Court: The stipulation has now been signed, has it, and it is all right?

Mr. Yardum: Yes, sir.

The Court: We can proceed with this case. I am ready for the opening statements.

Do you want to make an opening statement, Mr. Yardum?

Mr. Yardum: Yes.

The Court: I would like one of you to tell me, briefly, what this case is about, the issues that are involved.

Mr. Schessler: If it please the Court, your Honor, in the case of O. H. Kruse Grain and Milling versus the Commissioner, the petitioner is a California corporation.

The proceeding involved deficiencies of \$13,994.26 for 1952, \$19,192.33 for 1953.

The issues involved are a deduction for interest expense of \$12,000.00 and a deduction of rental expense of \$12,000.00 in 1952 and also in 1953.

In regard to the interest claimed as a deduction by the corporation, the Commissioner determined that no indebtedness existed within the meaning of Section 23 (b) of [5] the 1933 Internal Revenue Code and, further, that even if that indebtedness did exist, the interest expense was not paid during the taxable years 1952 and 1953 or within two and a half months following the close of the taxable years pursuant to Section 24 (c) of the 1939 Code.

Regarding rent, the Commissioner determined that the rental expense was not paid during the years 1952 and 1953, or within two and a half months following the close of the taxable years, pursuant to Section 24 (c) of the 1939 Code.

This corporation was organized in March, 1950, to take over hay, grain and feed business that was formerly owned by O. H. Kruse, individual, for about 14 years.

The corporation had an authorized capital stock of 3000 shares par value \$100.00 each.

Most of the assets on the balance sheet of the sole proprietorship, except certain real property, was contributed to the corporation, according to the books, on or about April 1st, 1950, for \$80,000.00 in stock issued to Mr. Kruse and his wife as joint tenants, a note of \$200,000.00 to Mr. Kruse and an open account of approximately \$18,500.00 to Mr. Kruse.

According to the corporate minutes, the note matured on December 31st, 1950, and bore six percent interest when paid at that time.



Respondent contends that the indebtedness to Mr. Kruse [6] was not bonafide in that an investment was intended and to subject the entire amount to the risks of the business and that he was not intended to be a creditor and have a definite obligation payable in any and all events.

In regard to Section 24 (c), respondent expects the evidence to show that even if there was an indebtedness, that the liability for interest was not paid or constructively received by Mr. Kruse for the years in question within the meaning of the regulations.

The rental issue relates to property owned by Mr. Kruse and rented to the petitioner.

The respondent expects that this rental liability was not paid to or constructively received by Mr. Kruse for the years in question within the meaning of the regulations.

The respondent will rely on the corporate records and the treatment by Mr. Kruse according to his income tax returns to show that the amounts were not constructively received by Mr. Kruse, to show that the treatment by the corporation and Mr. Kruse was not consistent in any of the years.

The Court: Just those two issues?

Mr. Schessler: Those are the issues, your Honor.

The Court: Do you have a stipulation to file?

Mr. Schessler: Yes, sir, your Honor. We have a stipulation that has been marked. [7]

The Court: The stipulation will be received.

Are you ready?

Mr. Yardum: I would like to make a short statement, your Honor.

You mentioned two issues. As I see this case, I believe there are three issues.

A primary issue, the one that I believe should be decided first, is whether this note which was given to Mr. Kruse and some \$18,000.00 on an open account and returned as sale of assets, part of the assets, which he turned into the corporation, whether that note actually represents a capital investment.

Now, if the answer is in the affirmative on that issue, we would not be concerned with the constructive receipt.

If the answer is no, that it is actually a note and was actually a sale from Mr. Kruse to the corporation, then we become concerned with the interest, whether it was constructively paid by the corporation and constructively received by Mr. Kruse personally.

The rent, of course, is in issue separate and apart from the note versus capital investment.

The constructive receipt issue is on that issue, regardless of the other.

That is all. [8]

The Court: Call your witness.

Mr. Yardum: Petitioner will call Mr. Fray Hobson.

FRAY L. HOBSON

was called as a witness by and on behalf of the Petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you take the witness stand? State your name and address for the reporter.

The Witness: My name is Fray L. Hobson—  
F-r-a-y L. H-o-b-s-o-n.

My address is 3850 West Sixth Street, Los Angeles.

I am a certified public accountant.

Direct Examination

Q. (By Mr. Yardum): Mr. Hobson, how long have you been an accountant?

A. I have been a certified public accountant since 1948.

I worked in the accounting profession between 1936 and my entrance into the Military Service of three years' duration and I worked in a public accounting firm from that date until 1948.

Q. Would you give the Court a little bit of your background, schooling, in accounting?

A. I am a graduate of U.C.L.A. At that time it was the Economics Department. They did not have a School of [9] Business.

Q. How about your experience in the accounting field? Can you give us a general idea of what you have done?

A. I worked two years for Haskins and Sells—  
H-a-s-k-i-n-s and S-e-l-l-s—upon graduation, certi-

(Testimony of Fray L. Hobson.)

fied public accountants, and from that time until the beginning of the war I worked as an accountant in the management firm for motion picture people.

When I returned from the Service, I went to work for Arthur Young & Company, Certified Public Accountants, and later for a Mr. Hunt. It was a firm of public accountants in Beverly Hills.

I worked for them for—until 1948, at which time I went into practice for myself.

I have been practicing for myself since that day on.

Q. Are you familiar with the——

A. Excuse me. The name is Edling, Hightower and Hunt.

Mr. Yardum: If you would speak up, Mr. Hobson, and address your remarks to the Court and the reporter, they will be able to hear you if you speak out a little bit.

Q. (By Mr. Yardum): Are you acquainted with the petitioner corporation, O. H. Kruse Grain and Milling? A. Yes, I am.

Q. Are you an officer of that corporation? [10]

A. I am assistant secretary of the corporation.

Q. How long have you kept books for that corporation? A. Since its inception, in 1950.

Q. Were you acquainted with O. H. Kruse prior to the incorporation of the corporation?

A. Yes. He was a client of mine from the year 1948.

(Testimony of Fray L. Hobson.)

Q. In your capacity as an accountant, did you keep the books for Mr. Kruse prior to the time the petitioner was incorporated?

A. Yes, I did.

Q. From 1948 to 1950, is that correct?

A. From 1948 to 1950, that is correct.

Q. I see. And you kept the books continuously after the incorporation? A. That is correct.

Q. I assume that you took care of the books all through the transition from the sole proprietorship to incorporation? A. That is correct.

Q. Now, under what name was the—did Mr. Kruse conduct his business prior to the incorporation in March of 1950?

A. O. H. Kruse Grain and Milling.

Q. What was—what is the corporation name?

A. O. H. Kruse Grain and Milling. [11]

Q. It is the same? A. Same name.

Q. Can you tell the Court why the same name was retained?

Mr. Schessler: I object to that, your Honor.

There is no foundation that this man would know why the corporate name was retained.

The Court: Overruled. He is an officer.

A. The corporate name was retained in order to realize in full on the goodwill of the milling business that had been conducted prior to incorporation.

Mr. Schessler: Excuse me. I didn't hear that answer.

(Testimony of Fray L. Hobson.)

The Witness: The exact name was used in order to realize fully upon the goodwill that had been developed over the years prior to the incorporation.

Mr. Schessler: I object to that answer, your Honor.

There is nothing in the record to show that the corporation had goodwill.

The Court: Overruled.

The Witness: It was retained in order to make an orderly transition from the operation as a sole proprietorship to the operation as a corporation.

Mr. Kruse felt that the people——

The Court: We do not want you to tell us what Mr. [12] Kruse felt.

Q. (By Mr. Yardum): Just what you know.

A. Many of the feeders and the dairymen who had been doing business with Mr. Kruse over the years were very valued clients and we didn't want any possible illwill or loss of goodwill to result from a change in the type of operation or in the transition from a partnership to corporate activity.

We felt that, in order to go on doing business as usual, that probably we could best accomplish that end by retaining exactly the same name.

Q. Mr. Hobson, I am going to show you a copy of the stipulation which is on file here and refer you to Item No. 5, which sets forth the assets which were turned in by Mr. Kruse to the corporation in return for the 800 shares of stock.

Will you examine that, please?

(Testimony of Fray L. Hobson.)

Mr. Schessler: Just a second. Before you answer that; your Honor, I don't understand that the stipulation says that it was turned in for 800 shares of stock.

Mr. Yardum: Well, in exchange for the stock.

There is no issue as to how much stock was issued.

The Court: Have you a copy of that stipulation that I can use?

Mr. Yardum: I am referring to Item No. 5, your Honor. [13]

The Court: Well now, frame your question.

Q. (By Mr. Yardum): Mr. Hobson, the assets listed in this Item No. 5, that is, office equipment, autos and trucks, machinery and equipment, less accrued depreciation, prepaid insurance and insurance deposits less premiums and cash, were turned into the corporation; is that correct?

Are you familiar with that, are you not?

A. That is correct, yes.

Q. How many shares of stock were issued to Mr. Kruse in return for those assets?

A. Eight hundred shares.

Q. Now, were there any other assets—wait. Let me finish the question.

Were there any other assets which were in use or owned by Mr. Kruse in his business as a sole proprietorship which were turned into the corporation at the same time that these assets were turned in for stock?

(Testimony of Fray L. Hobson.)

A. Yes. All of the intangible assets were transferred.

Q. Would you itemize those intangible assets?

A. It would include goodwill. It would include the trade name for his product. It would include contracts with feeding associations.

It would include favorable buying contracts. It would include a going organization which was capable of [14] doing the job.

Mr. Schessler: Your Honor, I object to this answer. These are conclusions of this witness as to what goodwill would include.

What was transferred by Mr. Kruse should be in some corporate record of some sort, and unless the corporate record would be available to us, I think that this witness is merely testifying from what he thinks might have been included.

Mr. Yardum: If the Court please, that has nothing to do with what he thinks.

It has nothing to do with a fact.

I asked him if there were any assets of O. H. Kruse which he had as a sole proprietorship, if there were any that were turned over to the corporation other than those listed here, and he is just testifying to the fact that there were, in telling what there was.

The Court: He says that there were other intangible assets and he is giving his definition of what he considers intangible assets.

The Court is not bound by that, merely explanatory of its statement.



(Testimony of Fray L. Hobson.)

The answer can stand.

Q. (By Mr. Yardum): Mr. Hobson, was there any stock or any other consideration given to Mr. Kruse—— [15]

A. In return for these so-called “intangible assets” which you itemized.

Mr. Schessler: I object to this, your Honor. He wouldn't know what was given to Mr. Kruse.

Mr. Yardum: He is an officer of the corporation, your Honor.

The Court: He is an officer of the corporation. He can answer if he knows if there was any stock.

The Witness: There was none.

Q. (By Mr. Yardum): In your experience as an accountant, Mr. Hobson, do you know whether it is the normal practice for these so-called “intangible assets” to be listed on the books of the corporation?

Mr. Schessler: I object to that, your Honor, as not being proper testimony from this witness.

He, I will agree, is an officer of the corporation.

All he has done is take care of the books of this corporation.

The Court: Well, he has laid quite a foundation as an expert.

This question calls for an answer by an expert.

He may answer.

A. Yes, it is quite usual. [16]

Q. (By Mr. Yardum): Quite usual——

A. For such intangibles as goodwill to not be carried on the books at a fair market value.

(Testimony of Fray L. Hobson.)

In fact, it would be rather difficult in some cases to carry them on the books.

Q. Now, in addition to the assets set forth in Item 5 of the stipulation, and in addition to the—I will refer to them as intangible assets which you described to the Court—were there any other property transfers from Mr. Kruse to the corporation at the time of the transition between—

A. At the time of the transition the—

Mr. Schessler: Your Honor, I would like the witness to give a definite time, instead of the time of the transition.

The Court: Isn't that definitely fixed in 1950 when this was incorporated?

The Witness: April 1st, 1950.

The Court: April 1st, 1950.

Mr. Yardum: That is when the transition took place, at any rate?

The Witness: The accounts receivable, the inventory and some cash—

Mr. Yardum: I see. Now,—

The Witness: —was transferred. [17]

Q. (By Mr. Yarum): Are those the items that were set forth in Item 7 of the stipulation?

A. In Item 7, yes.

Q. What, if anything, did the corporation give to Mr. Kruse in return for those assets?

A. The corporation gave a note for \$200,000.00 and the remainder of 18,000 plus was carried on as an open obligation as an account payable on the records.

(Testimony of Fray L. Hobson.)

Mr. Yardum: Your Honor, we are going to introduce certain documents in evidence which we will need back at the end of the trial, and I believe counsel will stipulate that we can substitute photo-stats in place of these.

Mr. Schessler: Yes.

The Court: Have them identified by the Clerk.

The Clerk: For identification, Petitioner's Exhibit No. 1.

(Petitioner's Exhibit No. 1 was marked for identification.)

Q. (By Mr. Yardum): The note that you referred to which you stated was—which was given to Mr. Kruse in exchange for the assets which he transferred listed in Item 7 of the stipulation, is that the note that I am showing you now?

A. Yes, sir. [18]

The Court: That is Exhibit 1.

Mr. Yardum: Plaintiff's Exhibit 1. We will offer it in evidence, your Honor.

Mr. Schessler: Respondent has no objection, your Honor.

The Court: Exhibit 1 will be admitted.

(Petitioner's Exhibit No. 1 was received in evidence.)

Q. (By Mr. Yardum): Mr. Hobson, can you explain a little more fully these intangible assets which you referred to?

A. As to the nature of them?

Q. As to the nature of them.

(Testimony of Fray L. Hobson.)

You mentioned some contracts. What were these contracts?

A. There are various cooperative feeding associations in the Bellflower-San Dimas area, the Chino Valley, Baldwin Park that cooperate—their members will buy from one source.

The Cooperative guarantees the accounts receivable for the purchases by its members.

They buy on terms that are tantamount to cash, ten-day account or 15-day account.

They will guarantee a markup over the current grain quotations to the producer of the feed. [19]

Mr. Schessler: Your Honor, I think he is testifying to what certain contracts are.

If he is, the contracts themselves are the best evidence of what they are.

Mr. Yardum: I think he was just explaining, your Honor.

The Court: Not really introduced for establishing any fact in those contracts.

Mr. Schessler: Yes, I know.

The Court: It is merely explanatory, I think, of what he had in mind when he said intangible contracts.

Mr. Schessler: I see.

The Court: It is true that the contracts would be the best evidence.

Do I understand that these contracts were assigned by Mr. Kruse when he was operating as a proprietor to the corporation?

Mr. Yardum: That is correct.

(Testimony of Fray L. Hobson.)

The Court: Have you got those contracts here?

Mr. Yardum: No, no, your Honor.

Q. (By Mr. Yardum): You referred, Mr. Hobson, to——

The Court: We will let him go on for a little more.

Q. (By Mr. Yardum): ——to goodwill. From what did you conclude that [20] Mr. Kruse had any goodwill in this business as a sole proprietorship?

A. Could you repeat the question, please?

Q. You told the Court that Mr. Kruse had turned goodwill, among other intangible assets, over to the corporation and received no consideration therefor.

I just want to know how you conclude that there was any goodwill.

What is the basis of your statement?

A. The milling business or the hay grain business that had been operated for years was a profit-making business, and when you transfer a profit-making business that continues to make profits, there undoubtedly is goodwill.

Mr. Schessler: He testified that he didn't come to work for this organization until 1948; so, unless he can show that he knows something about the business prior to that time, he can't say that they had profit for any years.

The Court: Well, two years, for what it is worth. I don't know as it would go to the admissibility. It might go to weight.

(Testimony of Fray L. Hobson.)

Q. (By Mr. Yardum): Let me ask you this: Did Mr. Kruse, acting as a sole proprietorship in this grain and milling business, have a profit in 1948? A. Yes, he did. [21]

Q. Do you know how much it was?

A. I can't remember just offhand.

Q. Do you know whether it was over or under \$50,000.00?

Mr. Schessler: Your Honor, he testified that he didn't know.

A. It was in excess of \$50,000.00.

Mr. Schessler: Excuse me.

The Witness: May I say this? When the time came to compute the excess profits credit for purposes of computing the income tax and excess profits tax liabilities——

Q. (By Mr. Yarum): In what years?

A. For the years beginning with 1950 and continuing until the excess profits tax, provision no longer applied; it was necessary to go back five years and to determine what the net profit had been for the previous five years.

Q. Do you recall what it was?

A. I do not recall. I could find out quite easily.

Q. You stated in 1948 it was in excess of \$50,000.00? A. It was in excess of \$50,000.00.

Q. How about in 1949?

Was it in excess of \$50,000.00?

A. It was in excess fifty, I believe.

Q. Did you ever make any computation in your capacity [22] as an accountant and as an officer of

(Testimony of Fray L. Hobson.)

the corporation as to the value of these intangible assets?       A. Yes, I did.

Q. I see. And in your opinion, from that computation, what was the value arrived at?

A. In excess of \$200,000.00.

Mr. Yardum: Counsel, you want me to lay a foundation for them?

Mr. Schessler: No. I have no objection to them.

Mr. Yardum: I want to have them offered.

The Court: Have them identified.

Mr. Yardum: These are the minutes of the incorporation of O. H. Kruse Grain and Milling, dated April 1, 1950.

It's also consent of the incorporators to the holding of the meeting.

The Court: That will be Exhibit 2.

The Clerk: Petitioner's Exhibit 2 for identification.

(Petitioner's Exhibit No. 2 was marked for identification.)

Mr. Yardum: We will have the same request in connection with these that we may withdraw them and put in the photostatic copy.

Next, Plaintiff will offer a minutes of the [23] meeting of the board of directors of O. H. Kruse Grain and Milling held on April 1, 1950, and the consent to the meeting.

The Clerk: Petitioner's Exhibit 3 for identification.

(Petitioner's Exhibit No. 3 was marked for identification.)

(Testimony of Fray L. Hobson.)

Mr. Yardum: Plaintiff would next offer the minutes of a meeting of O. H. Kruse Grain and Milling held on May 15th, 1950.

The Clerk: Petitioner's Exhibit No. 4 for identification.

(Petitioner's Exhibit No. 4 was marked for identification.)

Mr. Yardum: Plaintiff will next offer minutes of a meeting of the board of directors of O. H. Kruse Grain and Milling held on June 15th, 1950.

The Clerk: Petitioner's Exhibit No. 5 for identification.

(Petitioner's Exhibit No. 5 was marked for identification.)

Mr. Yardum: May we withdraw at this time, your Honor, the originals of May 15th and June 15th and put in their place photostatic copies or would you rather have it done all at the same time afterwards?

The Court: Let's see the copies. These are [24] pretty hard to read.

Mr. Yardum: We will have better copies made, your Honor.

The Court: It is pretty blurred.

Those are Exhibits 2, 3, 4 and 5?

The Clerk: That's right, sir.

Mr. Schessler: Respondent has no objection, sir.

The Court: They will be admitted.

The Clerk: Exhibits 2, 3, 4 and 5.

(Petitioner's Exhibits Nos. 2, 3, 4 and 5 were received in evidence.)



(Testimony of Fray L. Hobson.)

Q. (By Mr. Yardum): Mr. Hobson, I refer your attention to a letter dated September 9, 1955—

A. Yes.

Q. —addressed to the District Director of Internal Revenue—that is a copy of the letter—in re O. H. Kruse Grain and Milling, and it doesn't have any signature on it.

Can you identify that document?

A. Yes.

Q. Is that a letter from you to the District Director of Internal Revenue?

A. The computation was made by me.

Q. How about—

A. This is the computation— [25]

Q. This computation was made by you?

A. Yes.

Q. Whose letter is that?

A. I believe that's a letter from Mr. Mills—  
M-i-l-l-s.

Mr. Schessler: Your Honor, I think, unless he can make a more definite tieup as to just what that is—

The Court: He hasn't offered that yet.

Mr. Yardum: I haven't offered it yet.

I am trying to lay a foundation.

Q. (By Mr. Yardum): What was that computation? You say you made that—

The Court: Let's have this identified.

Mr. Yardum: Yes, sir.

The Clerk: For identification, Petitioner's Exhibit No. 6.

(Testimony of Fray L. Hobson.)

(Petitioner's Exhibit No. 6 was marked for identification.)

Q. (By Mr. Yardum): Now, you say you prepared this computation?

A. I prepared this computation.

The Court: Which is a part of Exhibit 6.

Q. (By Mr. Yardum): Which is a part of Exhibit 6. [26]

A. Yes, your Honor.

Q. And will you explain just what that computation was?

The Court: Just a moment. I would like to know more about this instrument.

If this is something that is not his letter, I don't want any testimony about it.

Mr. Yardum: I think he has said that the letter is not his but that the computation was.

I think he can testify as to what the computation was, what it was made for.

The Court: Well, I will ask him a few questions.

Who was it made for?

The Witness: This computation was made pursuant to a conference that we had in the Director's office in Pasadena with Mr. Carey and Mr. MacArtney—M-a-c A-r-t-n-e-y.

Mr. Carey was the Revenue Agent.

Mr. MacArtney was his group chief at the time.

The Court: To whom was that computation sent?

The Witness: The computation was sent to Mr. Mills for transmittal.

The Court: Who is Mr. Mills?

The Witness: The gentleman at the table.

(Testimony of Fray L. Hobson.)

The Court: What is his connection in the case?

The Witness: Tax counsel. Mr. Mills has a power [27] of attorney for the corporation.

Q. (By Mr. Yardum): What was this a computation of?

A. At the conference, Mr. MacArtney indicated——

Mr. Schessler: I object, your Honor, unless he can show that he was there.

The Witness: I was there.

Mr. Schessler: And when the conference took place.

The Witness: I could not tell you the exact day right now.

It was prior to September 9th.

The Court: This was sent to the District Director of Internal Revenue. Do you have an original of this?

Mr. Schessler: It's very possible that we have, your Honor.

The Court: That would eliminate everything, if you have the original.

Mr. Schessler: May I just give this to the gentleman over here and let him look through the file, if they can get the original?

The Court: If they have the original, I don't presume you have any objection at all?

Mr. Schessler: I have no objection at all, if we can find it.

We have the original, your Honor, of this letter.

(Testimony of Fray L. Hobson.)

The Court: You would have no objection then to [28] this going in evidence?

Mr. Schessler: I have no objection that the letter, not the contents, as to what the contents say. I will not object that the letter did go from Mr. Mills to the Director on this date.

The Court: Of course. I mean, you are, of course, not agreeing to the contents except that the letter was sent with this computation?

Mr. Schessler: I have no objection to that.

The Court: The exhibit will be admitted into evidence.

Now you can testify freely with respect to that.

Do you want the original in evidence, or do you want the copy?

Mr. Schessler: It's immaterial, your Honor.

The Court: If there is no objection made on the basis of this being a copy, why the copy is just as good.

Mr. Yardum: Yes, I know that, if it's all right with counsel.

The Court: Well, we will admit the copy and let the Government keep its original for its files.

Mr. Schessler: Now, there are some markings on this letter that are not on this letter.

Mr. Yardum: We will stipulate that they may be disregarded, what is printed in pen. [29]

Mr. Schessler: With that understanding, I have no objection.

(Testimony of Fray L. Hobson.)

Mr. Yardum: In fact, I think if we can draw a line through the writing — may I do that, your Honor, draw a line?

The Court: Yes.

The Clerk: Petitioner's Exhibit 6.

(Petitioner's Exhibit No. 6 was received in evidence.)

Q. (By Mr. Yardum): Now, please explain to the Court what this computation is.

A. This is a computation of the value of the goodwill and the trade name of O. H. Kruse Grain and Milling as of the date when it was transferred to the corporation.

The computation was made pursuant to a request by Mr. MacArtney that such computation be made, and it was made using a formula that Mr. MacArtney and Mr. Mills had agreed upon as being reasonable and fair and one that they would agree upon.

The method of computation is one that is in use in many cases.

I believe his reference is ARM 34 or something to that effect, Hoskold, I believe the name was.

It set the pattern for this computation. The [30] computation was made by me.

Mr. Yardum: I want to make this clear in my own mind, too.

Q. (By Mr. Yardum): There were certain assets transferred by Mr. Kruse for stock.

(Testimony of Fray L. Hobson.)

There were certain assets transferred by Mr. Kruse to the corporation for a note and some \$18,000.00 on open account.      A. That is correct.

Q. And there were certain assets transferred by Mr. Kruse to the corporation for which he received no consideration, is that correct?

A. That is correct.

Q. And this computation is in connection with the assets which were transferred by Mr. Kruse to the corporation for which he received no consideration? Is that correct?

A. No stock was issued for it.

Q. No stock was issued.

Did he get any cash?      A. No cash.

Q. Did he get a note for it?      A. No.

Q. The corporation didn't give him anything for it?      A. That's right. [31]

Q. Mr. Hobson, I refer your attention to—what do they call this?

A. This is a ledger, and this is a transfer binder. This also contains some of the journals—

Q. The journal is in a transfer binder?

A. In the transfer binder.

Q. Shall we refer to that as a ledger?

A. That will be proper, yes.

Q. I refer your attention to a ledger and a transfer binder with some tabs on the pages.

It says "Monthly Journals"—

The Court: Pardon me. I am going to take a recess for about ten minutes.

(Short recess.)

(Testimony of Fray L. Hobson.)

Q. (By Mr. Yardum): Mr. Hobson, going back a little ways as to the certain assets which were transferred by Mr. Kruse to the corporation for stock, certain assets transferred without consideration and certain assets transferred or sold in return for a note and \$18,000.00 on an open account; is that correct? A. That is correct.

Q. Could you explain to the Court why it was done in this manner, why the transition from a sole proprietorship to the corporation was done in this manner? [32]

A. Let me understand your question.

Why it was transferred partly for stock?

Q. Partly for a note and partly for an open account credit and partly for no consideration.

A. The business of O. H. Kruse Grain and Milling, plus the goodwill, was transferred—the business—the mill, the equipment, the bulk tank trucks and office equipment were transferred for stock plus some cash and some intangibles.

The intangibles, the prepaid insurance, of course, were transferred.

Of course, to have canceled the policies and have rewritten them would have incurred a loss.

They were of no value to any other than the milling operation.

The mill and the operation was transferred for stock because, well, that was the business. That was it.

The cash, the receivables and the inventory represented the entirety of Mr. Kruse's estate, repre-

(Testimony of Fray L. Hobson.)

sented his lifetime of earnings, except for a few small investments that he had made.

He wanted—he transferred the mill and the milling operation for the stock because he wanted to operate the business as a corporation.

He retained his lifetime savings in his estate because he had no desire—— [33]

Mr. Schessler: Your Honor, this——

The Court: Yes, of course, he can't tell us what Mr. Kruse wanted to do.

I don't understand what your question was. He has told us all these things before.

Your question was why did he do it this way.

Mr. Yardum: That's correct, your Honor.

The Court: Can you answer that specific question, why was it done this way?

The Witness: Perhaps I don't understand the question.

The Court: Well, I don't know as I do.

Is there something you are trying to bring out, why this was an unusual way and was done this way in this instance because of certain facts?

Mr. Yardum: I don't think it's unusual.

I want to know certain facts as to why it was done.

The Government has made a contention that this wasn't actually a note, wouldn't have been capital investment.

I think we should have a right to explain why it was done this way.



(Testimony of Fray L. Hobson.)

The Court: Sure you have, if he can give us an answer as to why it was done this way.

Mr. Yardum: I think he has given us a partial [34] answer in the rest of his testimony.

The Court: I think he has. Well, is there anything more?

Q. (By Mr. Yardum): Can you give us any more of an answer, Mr. Witness?

A. Yes. I sat in on the conference. I know why it was done.

Q. Just say why. If you know of your own knowledge, I think you can testify as to why it was done.

Don't say what Mr. Kruse thought, wanted, or—just why it was done.

Mr. Schessler: He should tell us who was present and where it was, if he is going to testify about a conference.

The Court: If it was done this way as a result of some conference, tell us what occurred.

The Witness: The conference was in the office of Mr. Kruse's attorney, Judge Wolford — W-o-l-f-o-r-d — of El Monte. Mr. Wolford handled the legal matters in connection with the incorporation from beginning to end.

Q. (By Mr. Yardum): Who else was present?

A. The three organizers. There was Mr. Kruse and his wife and the third one was Adolph Kruse.

Q. Were you present also? [35]

(Testimony of Fray L. Hobson.)

A. I was present. That was held in the office of Judge Wolford in El Monte and it was held in the early part of March, 1950.

That was the organizational meeting.

Q. I see. Now, you have given us certain reasons as to why the transaction was handled a certain way, and all I am trying to find out is if there are any further reasons as a result of this conference, I guess you can say them.

A. Mr. Kruse had a problem of having all of his personal funds in the one bank account which he used——

Mr. Schessler: That would be hearsay.

Mr. Yardum: It's a fact.

The Witness: I was——

The Court: Well, did that develop in the conference that that fact——

The Witness: Yes.

The Court: Thank you.

The Witness: Mr. Kruse had income or would have income up until the date when the transfer of the business of the corporation could be effected.

Provision had to be made for funds to pay his—to make his payments on his declaration of estimated tax for the year 1950.

He couldn't transfer all of his funds into the corporation. He had no desire to. That was his estate. [36] That was the accumulation of years——

Mr. Schessler: Your Honor, is this testimony to show what took place or the truth or what actually happened?

(Testimony of Fray L. Hobson.)

The Witness: This is the truth of what happened—

The Court: Excuse me. If you will just tell us what occurred at this conference.

The Witness: The conference, of course, was the organizational conference where the attorney—

The Court: I understand that. Now, what was said at this conference by whom?

The Witness: There was a discussion as to what was the grain business, what was to go into the corporation and which of the assets Mr. Kruse was going to retain himself, which of the assets he did not desire to put into the corporation for capital stock.

Q. (By Mr. Yardum): And the assets which he did not desire to put in for capital stock, are those the assets transferred for the note and the eighteen thousand some odd dollars open account?

A. That's correct.

Mr. Yardum: All right. You have answered the question.

Mr. Schessler: Your Honor, that type of testimony has to be hearsay.

I mean, what Mr. Kruse did and— [37]

The Court: Well, I take it all, Mr. Schessler, as being the result of this conference, what were the decisions that were made at this conference by those present.

I think that's what the witness is trying to tell us.

Mr. Schessler: All right.

(Testimony of Fray L. Hobson.)

The Court: And, of course, in a way, it has hearsay overtones, but, nevertheless, it is not introduced to prove the facts that were in the statement.

It is merely to prove that those statements were made, at least, by somebody at the conference.

Mr. Schessler: If that is what the witness contends, I have no reason to object to that.

The Court: Is that a fair summation, that those are the decisions that were made by those organizers of the corporation at that time?

The Witness: If it's borne in mind that Mr. Kruse was a client of mine and did rely upon me for financial information, I believe it's a fair summation, yes.

The Court: I am asking you if these decisions that were made at that time were the decisions to put in certain assets for certain stock—

The Witness: Yes.

The Court: —and things like that that you have testified about? [38]

The Witness: Yes.

Q. (By Mr. Yardum): Mr. Hobson, the sole proprietorship, at least from '48 when you represented Mr. Kruse, from '48 until the time of the incorporation, who ran that business?

A. Mr. Kruse, with the assistance of two key persons, Adolph Kruse, who is his mill supervisor, and a gentleman named Fred Schroder—S-c-h-r-o-d-e-r, who is his general manager and in charge of finance—or of the sales of the collections of the customer goodwill and so forth.

(Testimony of Fray L. Hobson.)

He is the man concerned with the matters other than the production affairs.

Q. Now, we have been referring to this as a sole proprietorship prior to March 27 or 28, 1950.

That indicates to me, anyway, that Mr. Kruse was the moving power behind the company.

Did he—was he?

A. Mr. Kruse was the business.

Q. Did he own it all himself?

A. He owned it outright.

Q. Were Mr. Schroder and Mr. Kruse his employees?

A. They are his employees, his key people.

Q. In other words, all of the decisions were made by Mr. Kruse?

A. The decisions, policy matters and so forth were [39] made by Mr. Kruse, yes.

Q. Now, after the incorporation, was there any change to speak of in this sort of management?

A. The management personnel was identical.

Q. I asked you whether there was any change in that type of management.

In other words, Mr. Kruse was making all of the major decisions?      A. That is correct.

Q. Of course, he may have relied on people for advice and guidance?      A. That is correct.

Q. Did he do the same after the incorporation?

A. That is correct.

Q. It was more or less under his complete control?      A. Yes.

(Testimony of Fray L. Hobson.)

Mr. Yardum: Will you mark this for identification?

The Clerk: For identification, Petitioner's Exhibit 7.

(Petitioner's Exhibit No. 7 was marked for identification.)

Mr. Yardum: Your Honor, we will make the same request in connection with this book as we have with the rest of plaintiff's exhibits, that is, we will want to withdraw on stipulation and refer to only certain pages which we will [40] have photostated.

The Court: Oh, yes. I don't want the book in evidence.

Mr. Yardum: You don't want the whole book.

Q. (By Mr. Yardum): Referring your attention to ledger sheets in a binder there are some tabs that say "Monthly Journals" and "General Journal," and it says, "Special Check Record"—"Check Register in 1953."

They are the only tabs—oh, no, one other tab, two tabs "General Ledger, 1951, 1952."

Can you identify this book?

A. This is the transfer ledger of O. H. Kruse Grain and Milling.

Q. I see. For what period of time?

A. April 1st, 1950, to December 31st, 1950, the year 1951 and the year 1952, and the year 1953.

Q. Does this book contain the complete journal entries and ledger for the years at issue here, 1952 and 1953?

(Testimony of Fray L. Hobson.)

A. Would you please ask the question again?

Q. As I understand accounting, there are journal entries and there are ledgers, is that right?

A. Yes.

There are many special journals, such as cash receipts receivables. [41]

Q. I want to know if this contains all the journal entries for the corporation for 1952 and all the journal entries for 1953 for the corporation and all of the ledgers for 1952 and all of the ledgers for 1953.

A. Without checking in detail, I would say that it is the complete ledger for the year 1952, for the year 1953.

Q. I see. And——

A. It is the complete general journal for the year 1952, the year 1953, and is a complete journal of the recurring journal entries for the year 1952 and 1953.

Q. I see. As the accountant for the corporation, were these entries prepared by you?

A. The entries were prepared by me, yes.

Q. In other words, all of the writing in there is yours?      A. That is correct.

Q. Mr. Hobson, as far as your books and records are concerned—not your books—I mean, the corporation's books and records are concerned, and Mr. Kruse's personal books and records which you kept prior to the incorporation, when did the transition take place from the sole proprietorship over to the corporation——      A. April 1st.

(Testimony of Fray L. Hobson.)

Q. —on the books?

A. April 1st, 1950. [42]

Q. The cash, \$41,348.08 is referred to in Item 7 of the stipulation.

Was there a new account opened to transfer that to the corporation?

A. No.

Q. Tell us what happened at that time as far as the cash is concerned.

A. The same bank account was retained in the same name.

There was an orderly transition from proprietorship to a corporation.

The same name and the same account were used.

Q. No change at all? A. No change.

Q. How about the accounts receivable? Were any of the debtors of Mr. Kruse personally notified that these accounts receivable had been turned over to a corporation in the same name? A. No.

Q. They were not notified? A. No.

Q. What changes actually took place during this transition, if any?

You don't know of any?

A. No. [43]

Mr. Schessler: What was the answer?

The Witness: No. He asked if I knew of any. I don't. It was a changeover from an operation as a sole proprietorship to the operation as a corporation.

Q. (By Mr. Yardum): Without any change in the name and without—and with any change in the



(Testimony of Fray L. Hobson.)

operation of the business the way they operated it?

A. That was the reason for using the identical name for an orderly transition.

Q. I see. Did you make out the income tax for Mr. Kruse personally?      A. Yes.

Q. Was he on a cash or an accrual basis?

A. He would be on—for which years, now? '52 and '53?

Q. 1952 and 1953.

A. He would be on the cash basis.

Q. Did the corporation rent anything from Mr. Kruse?

A. Yes. The corporation rented the real property on Tyler Street.

Q. Would you describe that property?

A. When Mr. Kruse originally acquired the mill from its previous owner, he also bought some real estate—

Q. I want to know what it was. [44]

A. —which included the whole mill. It included an old mill building.

Q. Tell us what kind of a building it was.

A. And a warehouse and a hay barn. He later acquired a small house, which he uses as an office, and constructed another hay barn.

Q. I see. What was the rent that the corporation—strike that.

Do you know what the value of that property would be, in your opinion?

A. That would be rather difficult for me to say. We did have an appraisal made of it.

(Testimony of Fray L. Hobson.)

Q. You did have an appraisal made of it?

A. Yes. I can't remember the figures.

Q. And what rent was the corporation paying for the property?

A. The rent that we considered fair was \$1000.00 per month, and that was confirmed by an appraisal.

Q. Now, on the books of the corporation, can you find the—How was the rent set up on the books?

A. The rental is set up at the end of each month for the rent during that month.

Q. All right.

A. At the end of January the rent is set up for the month of January, the entry is made by me each month, the [45] charge to the rental expense and of course an account with Mr. Kruse's credit for \$1000.00 each month.

Q. Can you find 1952, January 1952?

A. Yes. This is January. This is January, 1952.

Q. We refer to this as monthly journal entries—1952?      A. MJ.

Q. MJ. What does that mean?

A. When these are posted, that means monthly journal.

It's a method I use so that I didn't have to write the entire description each month.

Q. This is actually the second page in the book, the first page after the page with no writing; is that correct?      A. That is correct.

Q. And the front page contains January, February and March?      A. That is correct.

(Testimony of Fray L. Hobson.)

Q. And on the back, April, May and June?

A. Yes.

Q. And the next page, July, August and September, and on the back of that, October, November and December?           A. Yes.

Q. Now, is the rent, the thousand dollars a month, show up on these sheets?

A. Yes. The thousand dollars is charged to expense and it's credited to the account with Mr. Kruse. [46]

Mr. Schessler: Just a minute. If he is reading from this, your Honor, I wish he would read what it says.

The Witness: It says, "Interest," and it says, "Accrued Rent."

Mr. Schessler: Thank you.

Q. (By Mr. Yardum): Was that done in each month during 1952?           A. Each month.

Q. On the books?           A. Yes.

Q. What is the account that is credited?

A. Accrued rents.

Q. Would you find that account for us for 1952?

A. This is 1952.

Q. They have no page numbers, is that right?

A. No. I use the legend the name description only.

Mr. Yardum: Your Honor, may we refer to these as A, B, C and so forth?

The Court: I don't know. It's not going to be very clear in the record unless you make some refer-

(Testimony of Fray L. Hobson.)

ence that will identify the pages of the book that you are referring to.

Mr. Yardum: There are no page numbers, your Honor.

I think that if the pages that we are referring to may be referred to as Plaintiff's Exhibit 7 parenthesis and a small "a," is that all right? [47]

The Court: Any way you do it is all right, just so it is clear in the record.

Q. (By Mr. Yardum): The first page you are referring to, that is where you have the journal entries which show—

The Court: May I ask, are you going to introduce certain pages?

Mr. Yardum: Yes, your Honor.

The Court: Why don't you take them out of Exhibit A and introduce them—what is that?

Mr. Yardum: 7.

The Court: Exhibit 7.

Mr. Yardum: Will you take those out, Mr. Hobson?

The Court: Take out all of the pages that you are going to use.

Would it be harmful to your testimony if you took out all of the pages that you are going to introduce?

Mr. Yardum: Not at all.

The Court: Well then, do that.

Q. (By Mr. Yardum): I refer your attention to this—

(Testimony of Fray L. Hobson.)

The Court: Let's have that identified, those pages as 7-A; do you want them?

Mr. Yardum: Perhaps we can make them consecutively 7, 8, 9, and 10, now that we have gotten them out of the book? [48]

The Court: No. 7 will be no exhibit then.

Make that 7-A.

Mr. Schessler: Your Honor, there might possibly be some confusion as to just whose exhibits are what.

Perhaps I could suggest that the first one be 7 and the second one 8 and what have you.

The Court: Perhaps it would be better, because respondent uses letters.

Mr. Schessler: Yes.

The Court: I think you would be right.

Well, we will call that exhibit 7.

Mr. Yardum: This was marked 7 for identification.

The Court: So we will call the page that he gave you there Exhibit 7.

Mr. Shessler: Perhaps he should void that on the front.

The Court: Void Exhibit 7 as stated on this book.

(Petitioner's Exhibit No. 7 previously marked for identification was voided.)

The Clerk: Petitioner's Exhibits 7 and 8.

(Petitioner's Exhibits Nos. 7 and 8 were marked for identification.)

(Testimony of Fray L. Hobson.)

Mr. Yardum: Do you have any objection to our [49] introducing them into evidence at this time?

Mr. Schessler: Let me look at them. You are offering the front and back pages?

Mr. Yardum: Yes.

Mr. Schessler: Respondent has no objection, your Honor.

The Court: Exhibits 7 and 8 will be admitted.

The Clerk: Petitioner's 7 and 8.

(Petitioner's Exhibits Nos. 7 and 8 were received in evidence.)

Q. (By Mr. Yardum): On Exhibit 7, approximately two-thirds down the page, it says, "Accrued rent 1000 and it seems like it's credited to some account. A. That is correct.

Q. What is that credited to?

A. It's credited to an account designated "Accrued rent," which contains only the entries for rental payable to Mr. Kruse.

Mr. Schessler: Now,—

Mr. Yardum: Mark this for identification.

Q. (By Mr. Yardum): These are—

Mr. Schessler: I would like to ask a question at this point. He said it's credited to an account. [50] When he says "Credited to an account," that sheet just says, "Accrued rent."

The Court: Now, wait a minute. If you will tie that in by another question.

It is credited to an accrued account, was that it?

Mr. Yardum: Accrued rent account.

The Court: As shown on Exhibit 9, is that right?

(Testimony of Fray L. Hobson.)

Mr. Yardum: Exhibit 9.

The Court: That will be in the record then, so that we can read it.

Mr. Schessler: Thank you, your Honor.

The Clerk: Mark it for identification Exhibit 9.

(Petitioner's Exhibit No. 9 was marked for identification.)

The Court: Exhibit 9 is offered?

Mr. Yardum: Yes, it is offered.

The Court: You have no objection?

Mr. Schessler: No objection.

The Court: Exhibit 9 is admitted.

The Clerk: Petitioner's No. 9.

(Petitioner's Exhibit No. 9 was received in evidence.)

Q. (By Mr. Yardum): Does this Exhibit 9, accrued rent account, apply to any rent paid or owed by the corporation other than to Mr. O. H. Kruse? [51]           A. No.

Q. Is there any other rent account to which other rentals may be credited or debited?

A. A nominal rental is paid to Southern Pacific Railroad for properties leased from them.

The payments are made, I believe, quarterly or semi-annually.

Q. I am not interested in how they are made. Is there a separate account set up for that?

A. We don't accrue that. It's nominal, and we charge it when it's paid——

Q. When it's paid?           A. ——to expense.

(Testimony of Fray L. Hobson.)

Q. So the only accrued rent that the corporation could possibly have would be with Mr. O. H. Kruse personally?

A. The only one that is accrued and credited to this account, that is correct.

Q. Let me ask a question:

There is a note payable to Mr. Kruse for \$200,000.00.

How was the interest payment handled in the books of the corporation?

A. The interest payable to him is recorded as an accrued interest at the end of each month. [52]

Q. Just a moment. You are referring to Exhibit 7 now?

A. Exhibit 7 shows accruals for the months of January, February and March on the first side; April, May and June on the second side.

The \$1000.00 per month interest payable to him is accrued. It is charged to interest expense and it's credited to the accrued interest account, which is an account maintained with Mr. Kruse.

There are two other entries to the account.

Q. This accrued interest on Exhibit 7 which shows a thousand dollars each month for the first six months of 1952 and there is also accrued interest on Exhibit 8 which shows a thousand dollars a month for the last six months of 1952, that is the interest each month on the note which the corporation owed to Mr. Kruse; is that correct?

A. That is correct.

Q. The \$200,000.00 note?



(Testimony of Fray L. Hobson.)

A. That is correct.

Q. And Exhibit 7 shows in January that it's credited to an account, well, each month on Exhibit 7 and Exhibit 8 the thousand dollars is credited to an account.

What account is that credited to?

A. It is credited to the accrued interest account.

Q. Would you find the accrued interest account [53] in these records for 1952?

A. That is the accrued interest. (Indicating).

It contains only the credits for interest accrued and payable to Mr. Kruse.

The Clerk: For identification, Petitioner's Exhibit 10.

(Petitioner's Exhibit No. 10 was marked for identification.)

Mr. Yardum: We will offer it in evidence at this time, your Honor.

Mr. Schessler: We have no objection, your Honor.

The Court: Exhibit 10 is admitted.

The Clerk: Petitioner's Exhibit No. 10.

(Petitioner's Exhibit No. 10 was received in evidence.)

Mr. Yardum: May I—

The Court: He has to mark it.

Mr. Yardum: Oh, I'm sorry.

Q. (By Mr. Yardum): Does this show that in each month during 1952 Mr.—pardon me—this accrued interest account was credited with a thousand dollars each month?

The Court: Exhibit 10.

(Testimony of Fray L. Hobson.)

Q. (By Mr. Yardum): Exhibit 10, sorry. [54]

A. Yes.

Q. Is there any other interest which may be payable, that is, accrued, or actually paid by the corporation which would show up in this account?

A. No.

Q. Then, this account would apply only to the account with Mr. O. H. Kruse?

A. That is correct.

Q. On the interest due on the \$200,000.00 note?

A. That is correct.

Mr. Yardum: Would you mark these, please, Mr. Clerk?

The Clerk: As one or as two?

Mr. Yardum: Two, 11 and 12, in that order.

The Clerk: For identification, Petitioner's Exhibits 11 and 12.

(Petitioner's Exhibits Nos. 11 and 12 were marked for identification.)

Mr. Yardum: And 13 and 14, if you please.

The Clerk: For identification, Petitioner's Exhibits 13 and 14.

(Petitioner's Exhibits Nos. 13 and 14 were marked for identification.)

Q. (By Mr. Yardum): Mr. Hobson, I am going to refer your attention [55] to Exhibits 11 and 12 now.

The Court: Are they—

Mr. Yardum: They have not been offered yet. I just want to identify them a little more.

The Court: Is there any objection?

(Testimony of Fray L. Hobson.)

Mr. Schessler: No, your Honor. We have no objection if he makes a little further identification as to just what No. 12 is.

The Court: I see.

Q. (By Mr. Yardum): On Exhibit 11 it shows all of the accounts on the left, but on Exhibit 12 it does not show any accounts on the left.

Will you explain that so that we can tie these two exhibits together?

A. Yes. This is what in the accounting business we call a folio type of journal.

When they are installed in the binder, the facing pages open in a manner that you can cover a great many of months without writing in the explanation.

The figures on the face page of Exhibit 12 will correspond, line by line, with the description on Exhibit 11.

Mr. Schessler: Thank you.

The Witness: On the reverse side—— [56]

Q. (By Mr. Yardum): The reverse side of what?

A. On the reverse side where they are not facing pages, on Exhibit 12, the descriptions have been written in again.

Mr. Yardum: We will offer them in evidence, your Honor.

The Court: Exhibits 11 and 12 are admitted.

The Clerk: Petitioner's Exhibits 11 and 12.

(Petitioner's Exhibits Nos. 11 and 12 were received into evidence.)

(Testimony of Fray L. Hobson.)

Mr. Yardum: Plaintiff will offer 13 and 14 in evidence at this time, your Honor.

Mr. Schessler: Respondent has no objection.

The Court: The exhibits will be admitted.

The Clerk: Petitioner's Exhibits 13 and 14.

(Petitioner's Exhibits Nos. 13 and 14 were received in evidence.)

Q. (By Mr. Yardum). Exhibit 13 shows what appears to be 12 credits of a thousand dollars each.

Would you explain what those entries are?

A. Those are credits to the accrued rent account, which is an account maintained with Mr. Kruse—

Q. What year?

A. For the year 1953. They are entries recording [57] the accrued liability of \$1000.00 each month payable to Mr. Kruse.

Q. For what?

A. For the rental of the real property.

Q. On Exhibit 14 the accrued interest, that's a thousand dollars a month.

Is that also the interest on the \$200,000.00 note?

A. Yes.

Q. During 1953?

A. During 1953. It is an entry of \$1000.00 each month credited to the account with Mr. Kruse.

Q. You prepared these books. Did you start these books for the corporation? A. Yes.

Q. And all the entries were made by you?

A. Yes.

(Testimony of Fray L. Hobson.)

Q. You keep referring to the accrued interest and the accrued rent accounts as the accrued rent account with Mr. Kruse.

Why didn't you put Mr. Kruse's name in the account?

A. I prepared the ledger sheet. The ledger is in my possession or in Mr. Kruse's possession or in his custody and my possession, I should say, at all times.

The Court: The question was: Why didn't you put his name on it?

The Witness: I didn't feel it was necessary. [58]

The Court: That is your answer?

The Witness: Yes.

Q. (By Mr. Yardum): Why didn't you feel it was necessary?

A. We both knew what the credit was for. We both knew that \$1000.00 each month was payable to him and that's what the entry was for.

I prepared the entry myself. I prepared the financial statements for Mr. Kruse.

Mr. Schessler: Your Honor, I think the witness is testifying as to what Mr. Kruse knew from looking at these books, these entries, and I think that that is hearsay and not proper from this witness.

He can testify what he knew about it.

The Court: The answer may stand only to show why, to explain why he didn't put the name on the account. They both know.

To that extent, it is received.

Mr. Yardum: That's all right.

(Testimony of Fray L. Hobson.)

Q. (By Mr. Yardum): Mr. Hobson, how much rent was actually paid to Mr. Kruse during 1952?

Did your books reflect that?

A. Yes. The sheets have been removed.

Q. Well, I'll let you find the right one here, and [59] refer to it by exhibit number.

A. Was the question during the year 1952?

Q. Yes.

There was \$12,000.00 accrued rent. How much was actually paid to him?

A. None.

Q. How much rent was actually paid to Mr. Kruse in 1953 in connection with that thousand dollars a month?

A. Twelve thousand dollars.

Mr. Schessler: Your Honor, is this witness testifying from what appears on records or from what he knows of his own knowledge?

The Court: I thought he was going to testify from the records because his counsel handed him the records.

Mr. Yardum: I don't think he needs the records to testify to that.

The Court: Is there a record that shows that \$12,000.00 payment?

The Witness: Yes, sir.

The Court: Here it is, counsel.

Mr. Yardum: Will you mark that as Plaintiff's next in order?

The Clerk: For identification, Petitioner's Exhibit No. 15.

(Testimony of Fray L. Hobson.)

(Petitioner's Exhibit No. 15 was marked for identification.) [60]

Mr. Yardum: I offer it in evidence.

Mr. Schessler: Respondent has no objection to Petitioner's Exhibit No. 15.

The Court: Exhibit 15 is admitted.

The Clerk: Petitioner's 15.

(Petitioner's Exhibit No. 15 was received in evidence.)

Q. (By Mr. Yardum): I will ask again, Mr. Hobson, how much of the rent due to Mr. Kruse was actually paid during 1953?

A. Twelve thousand dollars.

Q. Now, you are referring to Exhibit 15?

A. Exhibit 15, yes.

Q. Can you identify the entry?

A. The payment on Check 384.

Q. The payment on Check 384?

A. Payment made by Check 384.

Q. Is that the second line from the bottom on which there is some writing? A. Yes, sir.

Q. Do you know, of your own knowledge, Mr. Hobson, how much of the interest owing to Mr. Kruse was actually paid to him in 1952?

A. If I may see the accrued interest sheets.

Q. Oh, you want to refer to the books again?

A. To the entry sheets. [61]

The Court: The book would be better, anyway.

A. There is no payment of interest in the year 1952.

The Court: As shown by the books?

(Testimony of Fray L. Hobson.)

The Witness: As shown by the books.

Q. (By Mr. Yardum): Was there any interest actually paid in 1953? Refer to your books.

A. A payment of \$2000.00 was made——

Q. Wait a minute, just wait a minute now.

Are you referring to this sheet here?

A. Yes.

Mr. Yardum: We are going to mark it for identification.

The Clerk: For identification, Petitioner's Exhibit No. 16.

(Petitioner's Exhibit No. 16 was marked for identification.)

Mr. Schessler: Respondent has no objection to Petitioner's Exhibit 16.

The Court: Exhibit 16 is admitted.

The Clerk: Petitioner's No. 16.

(Petitioner's Exhibit No. 16 was received in evidence.) [62]

Q. (By Mr. Yardum): I believe the question was how much interest was actually paid to Mr. Kruse in 1953 and you referred to Exhibit 17—16.

The Court: 16.

Q. (By Mr. Yardum): Can you now answer the question? A. Two thousand dollars.

Q. Is that the total amount paid to him?

A. Yes.

Mr. Schessler: As I understand it, your Honor, this witness is testifying that the entry on Exhibit 16 is \$2000.00 interest? Is that it?

The Witness: That is correct.



(Testimony of Fray L. Hobson.)

Mr. Schessler: I don't think—There is nothing on——

The Court: Well, you can cross examine him. The exhibit is in.

Mr. Schessler: Yes, sir.

Q. (By Mr. Yardum): How much of the \$12,-000.00 accrued rent did the corporation deduct on its income tax return for 1952 as an expense?

A. The entire amount, \$12,000.00.

Q. Twelve thousand dollars?

A. Yes. [63]

The Court: Of course, the income tax, the return, would be best. Is that in evidence?

Mr. Schessler: Not at this time, your Honor.

I have no objection to those going in as joint exhibits, your Honor.

The Court: Very well. What do you mark them now?

The Clerk: It will be Joint Exhibit 17.

The Court: A.

The Clerk: A, that's right, 17-A.

Mr. Yardum: 1953.

The Clerk: This will be the next exhibit.

Mr. Yardum: Next exhibit, joint exhibits.

The Clerk: For identification, Joint Exhibits 17-A and 18-B.

(Joint Exhibits 17-A and 18-B were marked for identification.)

The Court: The exhibits are admitted.

(Testimony of Fray L. Hobson.)

The Clerk: Joint Exhibits 17-A and 18-B.

(Joint Exhibits 17-A and 18-B were received in evidence.)

Q. (By Mr. Yardum): Mr. Hobson, your attention is referred to Exhibit 17-A. Please identify that document.

A. That is the U. S. Corporation Income Tax Return Form 1120 for the Year 1952 of O. H. Kruse Grain and Milling. [64]

Q. Was that prepared by you?

A. It was prepared by me.

Q. How much of the accrued interest—accrued rent of \$12,000.00 was deducted by the corporation in 1952 on that return, the corporate income tax?

A. Twelve thousand of the accrued was deducted.

Q. How much of the accrued interest on the \$200,000.00 note was deducted by the corporation as an expense on its 1952 return, Exhibit 17-A?

A. Twelve thousand dollars was, but I can't—There was additional interest on a bank loan.

Q. You can't tell from 17-A exactly how much it was? A. I will—\$12,000.00.

Q. I refer your attention now to 18-B. Will you please identify that document?

A. Exhibit 18-B is the U. S. Corporation Income Tax Return Form 1120, for the Year 1953 for O. H. Kruse Grain and Milling.

Q. Now, how much of the accrued rent, the rent due Mr. Kruse, that is, \$12,000.00, was deducted on the corporate income tax return in 1953?

(Testimony of Fray L. Hobson.)

A. Twelve thousand dollars.

Q. How much of the interest of \$12,000.00 due on the \$200,000.00 note due Mr. Kruse was deducted in 1953 by the corporation as an expense? [65]

A. Twelve thousand dollars.

Mr. Yardum: These will be——

Mr. Schessler: Joint Exhibits, your Honor, next in order, consecutive exhibits.

The Clerk: For identification, Joint Exhibits 19-C and 20-D.

(Joint Exhibits 19-C and 20-D were marked for identification.)

The Court: Exhibits 19-C and 20-D will be admitted.

The Clerk: Joint Exhibits 19-C and 20-D.

(Joint Exhibits 19-C and 20-D were received in evidence.)

Q. (By Mr. Yardum): I refer your attention to Exhibit 19-C and ask you if you will identify that document, if you can.

A. Exhibit 19-C is the U. S. Individual Income Tax Return, Form 1040, for the Year 1952 for O. H. and Helen D. Kruse.

Q. Did you prepare that return?

A. I prepared the return, yes.

Q. Now, you testified that the corporation deducted \$12,000.00 as an expense to each—to O. H. Kruse for rent during 1952.

How much of that \$12,000.00 was reported by [66] Mr. and Mrs. Kruse on their personal income tax return? A. Twelve thousand dollars.

(Testimony of Fray L. Hobson.)

Q. Now, you testified also that there was interest on the \$200,000.00 note in the sum of \$12,000.00 was deducted by the corporation as an expense in 1952.

How much of that interest was reported by Mr. and Mrs. Kruse on their personal return in 1952?

A. Six thousand dollars.

Q. Six thousand dollars?

A. Six thousand dollars.

Q. Would you please explain why the corporation deducted twelve and they reported only six?

A. It's an error.

Q. I refer your attention to Exhibit 20-D and ask you to identify that document.

A. Exhibit 20-D is the U. S. Individual Income Tax Return, Form 1040, for the Year 1953 of O. H. Kruse and Helen D. Kruse.

Q. Did you personally prepare that return?

A. Yes.

Q. Did you personally have charge of keeping the books individually for Mr. and Mrs. Kruse?

A. No formal records were kept for Mr. Kruse individually. He maintained a checking account at that time for the moneys that he received out of the rent, and he made [67] certain payments, such as taxes, and so forth, from his personal account.

Q. The rental due Mr. Kruse of \$12,000.00 was deducted by the corporation in 1953, \$12,000.00 worth.

How much of that was reported by Mr. and Mrs. Kruse in their personal return——

(Testimony of Fray L. Hobson.)

A. Twelve thousand dollars.

Q. —as income?

Now, the corporation also deducted \$12,000.00 interest on the \$200,000.00 note.

How much of that was reported by Mr. and Mrs. Kruse as income in 1953?

A. Twelve thousand dollars.

Q. What was the financial condition of the corporation during 1952 and '53?

A. Sound.

Q. Did the corporation have a line of credit any place with any banking institution?

A. The corporation had a one hundred thousand dollar line of credit with the Bank of America.

Q. Is it possible from your records or from your personal knowledge to tell the Court how much of that hundred thousand dollars was available each month during 1952? A. Yes.

Q. Would you so testify, please? [68]

A. Yes, I would.

Q. How much was available in January? I don't want to ask you each month. A. Of 1952?

Q. Yes. A. Sixty thousand dollars.

Q. February? Go through January and February, go through the year.

A. At the end of January—

Mr. Schessler: If this witness is going to testify from a document, I suggest we—

The Witness: I prepared a schedule of this.

Q. (By Mr. Yardum): You have prepared a schedule? A. Yes.

(Testimony of Fray L. Hobson.)

Q. Do you have it with you?

A. I prepared a schedule for Mr. Mills, tax counsel.

Q. Are you testifying from the books now or from your personal knowledge?

A. I am testifying from the books at this point.

Q. All right.

The Court: Is that a schedule?

Q. (By Mr. Yardum): This. (Indicating.)

A. Yes. [69]

Q. I am handing you a document that says on the top "O. H. Kruse Grain and Milling, Drawings Against Bank of America Line of Credit."

Is that the document you were just referring to?

A. Yes, sir.

Q. Did you prepare this document?

A. I prepared it, yes.

Q. And from what records did you prepare it?

A. I prepared it from the general ledger of O. H. Kruse Grain and Milling.

Mr. Yardum: May it be marked for identification?

The Court: Yes.

The Clerk: For identification, Petitioner's Exhibit 21.

(Petitioner's Exhibit No. 21 was marked for identification.)

The Court: I might state to counsel, that if that is admissible, it will be only admissible subject to check, and I wouldn't expect you to check it now.

(Testimony of Fray L. Hobson.)

Mr. Schessler: Respondent has no objection under those conditions, your Honor.

The Court: Exhibit 21 will be admitted, subject to check.

I understand that the data contained thereon is taken from books and records that are now in the courtroom. [70]

Mr. Yardum: That is correct.

The Court: Subject to that, it will be admitted.

The Clerk: Petitioner's Exhibit No. 21.

(Petitioner's Exhibit No. 21 was received in evidence.)

Q. (By Mr. Yardum): Exhibit 21, could you please explain that document?

The Court: Just generally, don't read it.

A. A hundred thousand dollar line of credit was extended to O. H. Kruse Grain and Milling by the Bank of America.

The corporation drew against this line of credit from time to time.

At no time did it withdraw all of it.

The first borrowing was in October of 1951. The maximum borrowing against it was 60,000 leaving an unused remainder of 40,000.

The final payment—paid back to the Bank of America was made in December of 1952, and from that time on it has not been used.

Q. (By Mr. Yardum): What was the purpose for which this line of credit with the Bank of America was established?

(Testimony of Fray L. Hobson.)

A. During the year 1951 the physical plant was extended quite extensively. New pelleting machinery, new feed [71] making machinery was established to handle the additional load of manufacturing of bulk feeds.

Q. When did that line of credit end? I'm sorry—

A. The final payment was made in December of 1952.

Q. Do the records of the corporation reflect the amount of cash on hand each month during 1952?

A. Yes.

Q. And 1953?           A. Yes.

The Court: Have you some tabulation of that? Have you made a tabulation of that?

The Witness: I don't have one here. I don't recall one.

The Court: All right.

Q. (By Mr. Yardum): This. (Indicating.)

A. Yes. That is the Bank of America.

Q. What is this?

A. That is the Bank of America—That is the ledger sheet that shows the Bank of America transactions and the balance on deposit with the Bank of America.

Mr. Yardum: Will you mark this for identification?

The Clerk: For identification, Petitioner's Exhibit 22.

(Petitioner's Exhibit No. 22 was marked for identification.) [72]



(Testimony of Fray L. Hobson.)

The Court: You have just about introduced the book.

Mr. Schessler: Respondent has no objection to this document—entry of the exhibit, your Honor.

The Court: Exhibit 22 is admitted.

The Clerk: Petitioner's Exhibit No. 22.

(Petitioner's Exhibit No. 22 was admitted in evidence.)

The Witness: I am in error. There are two sheets required.

The Court: Staple it on.

Q. (By Mr. Yardum): Now, referring your attention to Exhibit 22, identify that again, please.

A. Exhibit 22 is the general ledger account with the Bank of America.

Q. All right. Can you, from that document, tell us how much cash was on hand in the corporation in January of 1952?

The Court: Well, does the document show that?

The Witness: The document shows.

The Court: And does it show the amount that was on hand every month?

The Witness: Yes.

The Court: That's all we need to know.

Mr. Yardum: Nothing further. [73]

The Court: That is all we need to know rather than have him read it.

Q. (By Mr. Yardum): Do you have the equivalent ledgers for 1953? A. Yes, sir.

Mr. Yardum: Will you mark this for identification, please?

(Testimony of Fray L. Hobson.)

The Clerk: For identification, Petitioner's Exhibit No. 23.

(Petitioner's Exhibit No. 23 was marked for identification.)

Mr. Schessler: Respondent has no objection to Petitioner's Exhibit 23, your Honor.

The Court: Exhibit 23 is admitted.

The Clerk: Petitioner's Exhibit No. 23.

(Petitioner's Exhibit No. 23 was received in evidence.)

Q. (By Mr. Yardum): Exhibit 23, if you will, Mr. Hobson.

A. That is an account with the Bank of America.

Q. I see. Does this exhibit reflect the amount of cash on hand in the corporation each month during 1953? A. Yes, sir.

Mr. Yardum: You may cross examine.

The Court: I wonder, if we took the noon recess [74] at this time, if there would be any inconvenience to return at 1:30 because of this other case.

Would that be any inconvenience?

Mr. Yardum: Yes. I have another matter set in Municipal Court at 1:30, at which I am going to ask for a continuance.

The Court: That's enough. I just wondered if it would.

We will adjourn then until 2:00 o'clock.

Mr. Yardum: Thank you, your Honor.

(Whereupon, a recess was taken until 2:00 o'clock of the same day.) [75]

Afternoon Session—2:05 P.M.

The Clerk: We shall proceed with the trial in Docket 65683, O. H. Kruse Grain and Milling.

FRAY L. HOBSON

was called as a witness by and on behalf of the petitioner, and, having been previously duly sworn, resumed the stand and testified further as follows:

Mr. Yardum: If your Honor please, as we adjourned for the noon recess, we had just gotten through with our direct examination and said counsel could proceed.

But he has no objection to our opening up the direct examination for just some short testimony.

Counsel for the Government has objected to our Exhibit 21 which, if you recall, was a summary which was made from the books. And he wanted the ledger sheet introduced, with an explanation.

The Court: Do you have one ledger sheet that shows all this data?

Direct Examination—(Continued)

Q. (By Mr. Yardum): Is that correct?

A. It is included on here.

Q. It is included on one sheet?

A. The sheet includes other notes. [76]

Q. But everything that is in Exhibit 21 is reflected on this ledger sheet, notes payable?

A. That's correct.

Mr. Yardum: May we mark this for identification?

(Testimony of Fray L. Hobson.)

The Clerk: For identification, Petitioner's Exhibit 24.

(Petitioner's Exhibit No. 24 was marked for identification.)

Mr. Schessler: Are you offering it?

Mr. Yardum: I will offer it at this time.

Mr. Schessler: No objection.

The Court: Exhibit 24 will be admitted.

The Clerk: Exhibit 24.

(Petitioner's Exhibit No. 24 was received in evidence.)

The Court: In view of the fact that you did give some testimony with respect to Exhibit 21, you now state that Exhibit 24 contains all of the data that is shown on Exhibit 21, is that right?

The Witness: Yes.

Mr. Schessler: I would like to add a qualification.

That exhibit that shows amounts are from the Bank of America, 21.

Exhibit 24 does not show to whom the notes are running. That is our objection to that document. [77] It was submitted conditionally that we would be able to check the books to verify that those were the amounts outstanding to the Bank of America, and the books reflect—the information reflected on Exhibit 24 does not show that those amounts on Exhibit 21 are the amounts of the loans outstanding to the Bank of America.

The Court: You can bring that out on cross examination.

(Testimony of Fray L. Hobson.)

The exhibit has been admitted and there has been testimony about it.

Now, we have the explanation of the two exhibits, so I would rather leave it in the evidence with that explanation.

Mr. Yardum: Yes.

The Court: You can cross examine anything about it and bring it out further.

Mr. Yardum: That was my next question, your Honor.

Q. (By Mr. Yardum): Mr. Hobson, Exhibit 21 that you said was a summary of what we now have admitted as Exhibit 24, you said that Exhibit 21 contained everything that was in Exhibit 24, is that correct?

A. I do not believe that I said everything contained in Exhibit 21 is in Exhibit 24.

Q. Let me ask you this: Exhibit 21, was that prepared from the information contained in Exhibit 24? [78]

A. Yes. The information reflected in Exhibit 21 is reflected—is contained in the exhibit which is now Exhibit 24.

Exhibit 24 is the ledger sheet for the notes payable to the bank and to other individuals.

Q. All right. Now, is there anything in Exhibit 24 that is not used in computing and making up Exhibit 21? A. Yes.

Q. What is that?

A. There is a note for \$8000.00 which was assumed by the O. H. Kruse Grain and Milling Cor-

(Testimony of Fray L. Hobson.)

poration, the note being payable to a gentleman named Fred Schroder.

Q. That didn't have anything to do with the Bank of America?

A. Had nothing to do with the Bank of America.

Q. Are there any other entries on Exhibit 24 of notes payable that had nothing to do with the Bank of America?

A. There is a \$3000.00 note.

Q. Would you explain what that \$3000.00 note was?

A. I couldn't tell who it was.

Q. But it had nothing to do with the Bank of America?

A. Had nothing to do with the Bank of America.

It was a loan—there was a borrowing from an individual.

Q. Are there any other notes reflected on Exhibit 24, [79] notes payable, that had nothing to do with the Bank of America?

A. Yes. There is—May I see the records please, the books?

There is a note that was recorded in 1952 by journal entry for \$4329.57, which had nothing to do with the Bank of America, and there was a note for \$3000.00 which was recorded in December that had nothing to do with the Bank of America.

Q. Could you tell us what those notes are?

A. I can tell you to whom—

Q. I withdraw the question.

The Court: Do we need that?

(Testimony of Fray L. Hobson.)

Mr. Yardum: No. We don't need that.

Q. (By Mr. Yardum): In other words, there are four entries on this Exhibit 24, notes payable, the \$8000.00 entry, the \$3000.00 entry, the \$4329.00 and the \$3000.00 entry that had nothing to do with the Bank of America, is that correct?

A. Had nothing to do with the Bank of America.

Q. Everything else on Exhibit 24, notes payable, had to do with the Bank of America line of credit?

A. That is correct.

Q. Mr. Hobson, was that line of credit with the Bank of America in the amount of \$100,000.00 open during 1953?

A. Yes. [80]

Q. Looking at Exhibits 22 and 23, again, the figures on the right which say, "Balance" appear to be in red, some of them are in red and some of them are in pencil, red pencil and black pencil.

A. Yes.

Q. What does the black pencil indicate?

A. The black pencil indicates that that is the balance in the bank after deduction of all checks that were prepared after the end of the month but not issued until after the end of this month, had been deducted from the checkbook balance.

This would be the balance after all payables had been paid.

Q. I see. Now, the red pencil figures, what does that represent?

A. That would mean that after all the checks prepared to pay all the accounts payable as of the end of the month had been deducted from the

(Testimony of Fray L. Hobson.)

checkbook balance, that was an overdraft of \$12,000.00.

It does not necessarily mean as an overdraft on the bank. It means that after the end of the month balance is reduced by the amount of all accounts payable as of that date, this is the deficit of the cash required to pay all accounts payable.

Q. Then, you would say that there was actually [81] no overdraft at the time—at the dates that these figures indicate, such as 31st of December, I imagine, this \$12,000.00?

A. 31st of December. There would have been no actual overdraft, no.

This is, in effect, this is a composite of the bank account as a debit and the accounts payable, the trade accounts payable, as a credit.

Q. Go ahead.

A. As a matter of convenience and to avoid duplication in the accounting process, the check record is kept open for two weeks or until all of the bills are in.

Then checks are prepared in payment of those liabilities, and the checks are issued.

Those—The total of those checks that are issued during the, approximately the first two weeks of the month are included in the total checks for the month upon which the accounting work is being done by me.

That means that no accounts payable appear on the books.



(Testimony of Fray L. Hobson.)

They appear as a reduction of the cash account, in effect, as of the day on which the month ended.

They could have been shown as an account payable figure, thereby increasing this amount that is shown as cash but increasing as a contra item a credit in the records of balance of the accounts payable as of the identical date. [82]

Q. Would that explanation apply to Exhibits 22 and 23? Those are the two exhibits?

A. That would apply to the two, yes.

That procedure is followed to avoid having to list in detail the invoices for purchasing and then again duplicating the exact items by listing them in detail in the check register.

That is an accounting device.

Mr. Yardum: No further questions.

### Cross Examination

Q. (By Mr. Schessler): Mr. Hobson, when did you go to work for Mr. Kruse?

A. In the year 1948.

Q. Do you recall when in 1948?

A. It was in the spring.

Q. What were your duties at that time?

A. I am an independent certified public accountant.

I was operating as my own practice. I took over the accounts of the public accountant who had previously been doing his work.

Q. I see. Then, you were not employed on a full-time basis by Mr. Kruse at that time?

(Testimony of Fray L. Hobson.)

A. Oh, no.

Q. He was just one of your clients?

A. He is one of my clients. [83]

Q. In 1948, I'm talking about. A. Yes.

Q. He was one of your clients at that time?

A. Yes.

Q. How long, or how much time did you spend in, say, 1948, 1949, working on Mr. Kruse's books—I mean, roughly speaking.

Did it take a long time or just how much time?

A. Probably three days each month.

Q. And what about 1950? A. The same.

Q. 1951? A. Yes.

Q. 1952? A. Every year.

Q. Through 1953 perhaps three days a month?

A. Through 1953, yes.

Q. Specifically what did you do for him three days a month?

A. I do the general ledger work for him.

I review the journals that are written up for him by his regular employees.

I prepare his confidential payroll for him.

I prepare the payroll tax returns and so forth.

Q. Just regular accounting functions? [84]

A. I think of myself, I believe he thinks—well, strike that.

I am his accounting department, as such.

Q. I see.

A. The cash journals and the sales journals are prepared by clerical-type help.

I review them. I post the general ledger.

(Testimony of Fray L. Hobson.)

Q. You review the journals and post the ledger?

A. Yes.

Q. In 1950, I believe, you testified that Mr. Kruse transferred his business from a sole proprietorship to a corporation.

I believe you stated that the books reflecting this took place on April 1st, 1950; is that correct?

A. Yes, that is correct.

Q. You, I think, have the corporate ledger sheets, I believe you described them as such, in front of you? A. Yes.

Q. Would you show me the entries that were made—that were made in April, 1950, to record this transaction?

A. I believe that these were identified as ledger sheets for the years '51, '52 and '53, with the journal entries for the years 1952 and '53.

Q. Are you stating that you don't have what I am asking for? [85]

A. They are not in here, no. I do not have it here.

Mr. Schessler: Do you mind if I look at that?

Respondent requests that this sheet be marked as Exhibit C, I believe.

The Court: No. E, isn't it?

You had a 20-D?

Mr. Schessler: Excuse me.

The Clerk: For identification, Respondent's Exhibit E.

(Respondent's Exhibit E was marked for identification.)

(Testimony of Fray L. Hobson.)

Mr. Schessler: Respondent requests that this sheet be marked next in order.

The Clerk: For identification, Respondent's Exhibit F.

(Respondent's Exhibit F was marked for identification.)

Mr. Schessler: Thank you.

Q. (By Mr. Schessler): I hand you what has been marked Respondent's Exhibit E and ask that you identify that sheet, please.

A. That is the capital stock account from the general ledger of O. H. Kruse Grain and Milling.

The Court: I didn't hear you.

The Witness: It is the capital stock sheet from [86] the general ledger of O. H. Kruse Grain and Milling.

Q. (By Mr. Schessler): Could you tell me the date that refers to?

A. Yes, April 1st, 1950, the date the assets were transferred.

Mr. Schessler: Respondent offers Exhibit E at this time.

Mr. Yardum: No objection.

The Court: Exhibit E is admitted.

The Clerk: Exhibit E.

(Respondent's Exhibit E was received in evidence.)

Q. (By Mr. Schessler): I hand you what has been marked as Respondent's Exhibit F and ask that you look at that sheet and identify it, please.

A. That is the sheet from the general ledger of

(Testimony of Fray L. Hobson.)

O. H. Kruse Grain and Milling which reflects the liability of the corporation to O. H. Kruse.

Q. And does that sheet tell us when that entry was made?

A. It was made as of April 1st, 1950.

Q. As of that date? A. As of that date.

Mr. Schessler: Respondent offers Respondent's Exhibit F at this time. [87]

Mr. Yardum: No objection.

The Court: Exhibit F is admitted.

The Clerk: Exhibit F.

(Respondent's Exhibit F was received in evidence.)

Q. (By Mr. Schessler): Now then, the books of the corporation reflected that the corporation owed Mr. Kruse \$200,000.00 as of May 1st, 1950.

Mr. Yardum: Your Honor, I am going to object to the question on the grounds that it is outside of the scope of the direct examination. I won't object to the question if he makes this man his witness.

The Court: All right. I thought there was a great deal of talk about the \$200,000.00 obligation.

Mr. Yardum: Well, there was no — the entire books were not in evidence.

Now, he has got these in as his own evidence.

The Court: Did he testify that there was a \$200,000.00 obligation owed to Mr. Kruse?

Mr. Yardum: Yes.

The Court: Well, what is your objection?

The question was more or less preliminary, I thought, to another question. [88]

(Testimony of Fray L. Hobson.)

Mr. Schessler: Yes.

Mr. Yardum: All right. Are you ruling on the objection, your Honor?

The Court: I don't get your objection.

You say it is not proper cross examination?

Mr. Yardum: I thought he was asking about the—Well, I withdraw the objection.

The Court: Has he answered the question?

Mr. Schessler: No, he hasn't, your Honor.

Will the reporter please read the question?

The Court: Will you read it, please?

(The record was read.)

The Witness: May I see the ledger sheet?

As of May 1st?

Q. (By Mr. Schessler): No, April 1st, April 1st.

The Court: I think you said May 1st. I think you meant April 1st.

A. As of April 1st, the corporation owed Mr. Kruse \$18,579.29.

Q. (By Mr. Schessler): And how much of that was represented by a note? A. \$200,000.00.

Q. I believe you testified that you were an officer of the corporation, is that correct? [89]

A. Yes.

Q. When were you made an officer?

A. I do not recall.

Q. Were you an officer on April 1st, 1950?

A. Without reference to the minutes, I would not know.

Q. What is your—what office or position do you hold? A. Assistant secretary.

(Testimony of Fray L. Hobson.)

Q. And what are your duties as assistant secretary?

A. I am assistant secretary in order to authorize me or qualify me to sign various of the payroll tax returns, sales tax returns, to enable me to deal with certain matters such as the bank as an officer of the corporation.

Q. You don't know when you were made an officer?

A. I do not remember.

The Court: He says he can get it with the minutes.

Have we got the minutes in the courtroom?

Mr. Schessler: Your Honor, as far as I know, we have some of the minutes in the courtroom.

I can hand Petitioner's Exhibits 2, 3 and 4 to him.

The Court: Well, if the date's important, I think we ought to get it, because it is understandable he would not remember, but we can certainly determine it if you want to know it.

Mr. Schessler: He has testified that he knew a lot of things about the corporation, and one of the [90] reasons he knew them was because he was an officer.

The Court: Yes. I say, if you want to find out the date, we can get it.

It is understandable that he wouldn't remember it.

Mr. Schessler: Oh, yes, sir.

The Court: But we have records here that ought to be able to tell us.

(Testimony of Fray L. Hobson.)

Mr. Schessler: Apparently, your Honor, there is no information on that in the court.

The Court: In the minutes, isn't there? He said he could tell if he could see the minutes.

Mr. Schessler: Do you have the minutes?

Mr. Yardum: There are no minutes, other than what is there.

There may be other minutes, but we don't have them.

The Court: Will any of those instruments tell when you were made an officer?

The Witness: I haven't found them yet.

Mr. Schessler: Your Honor, at this point, I would like to inform the Court that I requested all of the books and records of this corporation, and I now find out that they don't have all of the minutes.

I previously found out that there were other books and records that were not brought in today.

I did not issue a subpoena or a notice to produce. [91] However, we discussed this on at least two prior occasions that I wanted records.

I didn't specify because I didn't know just what were in all the records.

The Witness: I do not see it in here.

Q. (By Mr. Schessler): Well, then, can you testify as to what this corporation did in 1950, if you were—if you don't know whether you were an officer at that time?

Aside from your accounting duties to enter the information from the journal into the ledger, aside from those duties, can you testify as to just what



(Testimony of Fray L. Hobson.)

your duties were as far as this corporation was concerned in 1950?

Mr. Yardum: I think he has—I object to the question.

He has already answered it, your Honor.

The Court: Overruled.

A. The actual date when I was made the assistant secretary I do not know.

I have been the accountant, the auditor for Mr. Kruse since 1948.

I was present at the conferences when they went into the details of the organization of the corporation as advisor in the office of Judge Wolford in El Monte.

I set up the records. I worked with Mr. Wolford [92] in connection with the incorporation.

Q. (By Mr. Schessler): In what way did you work with him?

A. Providing statements as required, providing information as required.

Q. Just usual, routine accounting features, so far?

A. Not necessarily routine, but accounting function, the function of an independent C.P.A.

Q. I meant routine accounting functions.

A. Not necessarily routine. It is an accounting function.

Q. Well, what did you do, aside from your accounting functions, in 1950?

You testified that you worked three days, approximately three days a month on this operation.

(Testimony of Fray L. Hobson.)

A. Yes. I do all of their accounting, the general accounting.

Q. Isn't it true that that's your major job, is just to take care of the books and records of this corporation?

A. Yes. As such, I'm familiar with it.

I'm not claiming otherwise.

Q. You are familiar with the workings of this corporation because of your duties as an accountant the three days each month?

A. Yes. I am available for call at all other times.

Q. A few moments ago you looked at the [93] corporate minutes, Petitioner's Exhibits 2, 3 and 4.

I invite your attention to Exhibit 4 and ask that you look at it so that you can be familiar with what it contains.

I am particularly interested in the offer of Mr. Kruse to transfer certain assets to the corporation in exchange for stock.

Are you familiar with what the minutes say about that?

A. Yes. I would like to read them, though, however.

Q. Are you familiar now with what the minutes, Petitioner's Exhibit 4, have to say about Mr. Kruse's transfer of assets in exchange for stock?

A. Yes.

Q. Do those minutes indicate that that transaction has taken place?

A. The minutes make an offer based upon a statement as of March 31st.

(Testimony of Fray L. Hobson.)

You have to bear in mind it takes time to develop a statement as of March 31st.

This meeting was held when that statement became available, when I was able to compile the figures.

It is impossible to present a statement that is—that is usable for purposes of obtaining stock permits and [94] so forth as of the day following the end of the month.

Q. Of course, we have the minutes in the record, so we don't have to belabor the point.

I am referring now to Petitioner's Exhibit 5.

I invite your attention to the resolution on the second page of that exhibit.

A. Yes.

Q. According to that resolution, the officers were directed to execute a loan to Mr. Kruse, execute a note in Mr. Kruse's favor.

A. Yes. It doesn't say the reason; it says note.

Q. Yes. And that is dated June 15th, 1950, is it not?

A. Yes.

Q. I invite your attention to the next to the last paragraph in order to perhaps refresh your recollection.

Maybe it will be unnecessary, but I would like to know if there are any provisions concerning the application of payments to Mr. Kruse on interest and on rent and on the open account.

A. The minutes specified that the payments are to be applied first to an accrued interest, secondly to accrued rental, and then to open account.

(Testimony of Fray L. Hobson.)

Q. And those minutes specify that interest is to start on January 1st, 1951, is that correct? [95]

A. That is correct.

Q. Could you tell me what the books, the account books reflect for interest on the loan to Mr. Kruse for the year 1950?

Mr. Yardum: I object to the question as being incompetent, irrelevant and immaterial.

The Court: Overruled.

A. As of December 31st an entry was made accruing \$9000.00 rental payable to Mr. Kruse and \$9000.00 interest payable to Mr. Kruse by agreement.

When the 1950 return was reviewed, that error was corrected.

Q. (By Mr. Schessler): I would like to be certain I understand just what you are saying, Mr. Hobson.

This entry was made on the books showing that it was owed to Mr. Kruse?

A. There was an entry—What was your question originally? I thought I had answered the question.

Q. What did the books reflect in regard to interest for the period April 1, 1950, through December, 1950?

A. An entry was made to record interest expense and to record accrued interest payable to Mr. Kruse.

Q. And then the method used was not the same as that used in, say, 1952 and 1953? [96]

(Testimony of Fray L. Hobson.)

Mr. Yardum: I object to that. The books will speak for themselves, whether they are the same or not.

Mr. Schessler: The witness should know what the books say.

The Court: Well,—

Mr. Yardum: You are arguing with the witness then.

The Court: Let the witness point to any of these entries.

You asked him what the books show. If the books show anything, let's see what the books show.

Mr. Schessler: I certainly would like to see myself, your Honor.

Those entries are not available to us.

The Witness: I believe that the sheet showing accrued interest liability has been submitted previously.

As of what date, sir?

Q. (By Mr. Schessler): The entries in the books for the period April 1st, 1950, through December, 1950.

A. I do not have the sheet showing accrued interest as of December 30th, 1950.

Apparently, there was none.

The Court: I can't hear you.

The Witness: Apparently there was no accrued interest shown as payable to Mr. Kruse as of January 31st, 1951. So,— [97]

The Court: As of what?

(Testimony of Fray L. Hobson.)

The Witness: As of January 1st. Each year—The accrued interest account, a liability for accrued interest, was not outstanding as of December 31st, 1950. I do not have the sheet here.

It was not carried forward to the transfer—to the new ledger.

The Court: Just a minute. I want to get this straight.

You were asked what the books showed with respect to the accrual of the interest for the period April 1st, 1950, through the month of December, 1950, and you replied that the books showed the accrued interest.

Now, do you find that entry in the books?

The Witness: I see no sheet for accrued interest.

The Court: Well then, your answer is different, is it?

The Witness: Is there another sheet that has been removed earlier?

Do I have them all?

Mr. Schessler: Mr. Hobson, I asked for all of the sheets, and I was advised that they would all be here.

It is my impression here today that they are not all here. [98]

Mr. Yardum: What is counsel inferring, that we have taken sheets out of this book or something?

Mr. Schessler: I am inferring that you do not have the entries for May 1st, 1950.

The Court: April 1st.

(Testimony of Fray L. Hobson.)

Mr. Schessler: April 1st, 1950, through December, 1950.

The Witness: We have the sheets for 1952 and 1953.

Mr. Schessler: Yes. I specifically asked counsel to bring the books for the period 1950, 1951, 1952 and 1953, and each time I made that request, I was advised by counsel that those years were immaterial and that they would not be properly before the Court; and I asked that they furnish them and I would attempt to introduce them and let the——

The Court: Do you know that they were not going to furnish them?

Mr. Schessler: My last telephone conversation was yesterday, and I said, "Please bring them, because I am going to attempt to introduce them into evidence."

And I said, "I'm sure that we will need those to get a complete picture of the transaction," and at that time I was not—I just wasn't sure what they were going to do.

This morning I found out that they do not have them.

I had a subpoena prepared to serve on Mr. Kruse [99] in the event that they were not here this morning, and Mr. Kruse himself is not here, so I was unable to serve the subpoena.

I think the same situation exists for the year 1951.

The Witness: Exhibit 10, accrued interest, 1951.

(Testimony of Fray L. Hobson.)

Q. (By Mr. Schessler): This is the ledger account.

Do we have the journal entry?

A. Yes, you have an exhibit for that, too.

Oh, for the year '51? No. These are the journals for the year '52—the years '52 and '53.

This is the general ledger for the year '51 which was handled in exactly the same manner.

Mr. Schessler: Your Honor, I will attempt to get this information in the record by using the '52 and '53 and ask if the '50 and '51 were handled in the same way, and perhaps that would enable us to do that, if I may.

The Court: All right. Go ahead.

Q. (By Mr. Schessler): Will you look at the journal entries for accrued interest for 1952 and 1953 appearing on Petitioner's Exhibits 7 and 8?

Those are for 1952.

I ask you, Mr. Hobson, please, would you tell me [100] if—if the accrued interest was handled in the same fashion for the period April 1, 1950, through December 30th, 1950?

Mr. Yardum: Object on the grounds that it is irrelevant and immaterial.

The Court: Overruled.

A. The accrued interest payable was recorded by a journal entry.

Q. (By Mr. Schessler): By whom, sir?

The Court: That wasn't the question. Was it the same or different?



(Testimony of Fray L. Hobson.)

The Witness: Could you please clarify your question? By "the same" I do not——

Mr. Schessler: Your Honor, counsel knows—May I confer with counsel?

The Court: Yes.

(Discussion off the record.)

Mr. Yardum: We have a stipulation, your Honor.

We will stipulate that the interest, accrued interest on the \$200,000.00 note was treated the same on the books of the petitioner corporation in 1951 and 1950 as it was in 1952 and 1953.

Mr. Schessler: Respondent so stipulates.

Q. (By Mr. Schessler): Mr. Hobson, would you please look at the corporate [101] records there in front of you and tell me if in any of those corporate books there is any account which shows accrued interest or accrued rent payable to Mr. O. H. Kruse for any time that we have records available?

Do you understand the question, Mr. Hobson?

A. I have answered a similar question before.

In fact, I have answered the same question before.

My answer before was that at the end of each month an entry was made recording the liability for accrued interest payable to Mr. Kruse.

The question——

Q. Excuse me, I'm sorry.

A. The question—I also stated that at the end of each month an entry was made, I believe it pertained to the years 1952 and '53, recording the ac-

(Testimony of Fray L. Hobson.)

crued liability payable—or the accrued rent payable to Mr. Kruse.

We showed the sheets. They were placed in evidence, showing the account to which—the account to Mr. Kruse to which those entries were made.

I was asked why it did not show the name Mr. Kruse on the sheet. My answer at that time was, “I didn’t think it was necessary.”

Q. I understand your testimony then to be that there is nothing on these sheets that indicate that accrued interest or accrued rent was owing to Mr. Kruse? [102]

Mr. Yardum: The sheets will speak for themselves; I object.

The Witness: I believe you——

Mr. Schessler: I’m sorry.

Mr. Yardum: He was answering while I was trying to object.

The Court: I think it is clear enough. The sheets do not have Mr. Kruse’s name on them.

Mr. Schessler: Thank you, your Honor.

Q. (By Mr. Schessler): Are there any entries in the corporate records that are before you which indicates that any amounts for interest or rent were set aside, taken out of the corporate funds, so to speak, and set aside for Mr. Kruse, that were earmarked for Mr. Kruse?

A. By “earmarked” do you mean placed in a special account?

Q. Yes.

A. No. There would be no reason for it.

(Testimony of Fray L. Hobson.)

Q. There is no corporate record then showing that any——

A. Perhaps I misunderstand your question.

The journal entry which records a liability payable to Mr. Kruse, in effect, shows that an amount is payable to him and acts to set aside funds to pay it. [103] You are referring, I presume, to the actual setting up of a sinking fund account to provide actual cash to meet this liability, is that correct?

Q. That is correct.

A. No. Such a thing wouldn't be necessary.

Q. The only things that we have referring to the accruals of rent and interest are the documents that have already been introduced in evidence, is that correct, Mr. Hobson?

A. You are asking now about the books of account?

Q. That is correct.

A. The books of account in the ledger that reflect the obligation to Mr. Kruse have been introduced.

Mr. Schessler: Thank you.

Respondent requests that this document be marked for identification next in order.

The Clerk: For identification, Respondent's Exhibit G.

(Respondent's Exhibit G was marked for identification.)

Q. (By Mr. Schessler): Mr. Hobson, I hand you what has been identified as Respondent's Ex-

(Testimony of Fray L. Hobson.)

hibit G and ask, if you can, tell me what it represents.

A. The United States Corporation Income Tax Return, [104] Form 1120, for the Year 1950, for O. H. Kruse Grain and Milling.

Q. And does your name appear on that?

A. Yes. I prepared the return.

Mr. Schessler: At this time, Respondent offers into evidence Respondent's Exhibit G.

Mr. Yardum: Object on the grounds it is irrelevant and immaterial.

The Court: For what purpose?

Mr. Schessler: I want to show that the corporation deducted interest on the note when the terms of the note did not call for interest until 1951.

The Court: The exhibit will be admitted.

The Clerk: Respondent's Exhibit G.

(Respondent's Exhibit G was received in evidence.)

Q. (By Mr. Schessler): I believe that we have your testimony before the Court that the corporation accrued interest and accrued rent payable to Mr. Kruse in 1950.

Could you look at that return and tell me if they deducted those accruals? A. Yes.

Q. I believe you testified that you prepared Mr. Kruse's return? [105] A. Yes, sir.

Q. Do you know how Mr. Kruse treated those items?

Mr. Yardum: I object to that; the return would be the best evidence.

(Testimony of Fray L. Hobson.)

The Court: Sustained. That's true, you must have the return.

Mr. Schessler: Your Honor, I do not have the original return. I do not have a copy of the return.

The only information that is available at this time is a Revenue Agent's — copy of a Revenue Agent's report that is in the petitioner's possession.

I thought that all of these documents were in the return—in the file until I found out three days ago that they weren't there, and at that time I asked counsel for petitioner to—if they would give that information to me.

The returns——

The Court: What was his reply?

Mr. Schessler: The first time, the information would be that he would give me all information that was necessary.

Mr. Yardum: Just a minute, now. Are you talking about me, counsel?

Mr. Schessler: Well, at that time you were not the counsel.

The Court: Well, the Government ought to have [106] its returns here, if it wants to.

If we are going to talk about some income tax returns, the Government certainly has a way of getting income tax returns.

Mr. Schessler: Well, Mr. Hobson prepared the returns. He can testify——

The Court: I don't like him to testify about what is in them.

(Testimony of Fray L. Hobson.)

The returns themselves are the best evidence of what is in them.

Have you copies of the return available?

Mr. Yardum: No.

Mr. Schessler: No, sir. But this morning, counsel advised me that if we could get testimony in as to 1950, that he would stipulate as to Kruse's treatment—

Mr. Yardum: Wait just a minute. You are putting words into my mouth.

I never told you that I would do that.

I don't know what you wrote down, but I don't know anything about that.

I am certainly not bound by it.

The Court: The evidence is in. I let evidence in with respect to 1950.

Mr. Schessler: Your Honor, we discussed that this morning and he looked at the Revenue Agent's report this [107] morning to see how it was treated, and I was of the impression, I'll state it that way, that counsel would agree that if you would let evidence of that nature in as to how it would be—perhaps I misunderstood counsel.

Mr. Yardum: I have never seen the return, your Honor. How can I agree to stipulate to something I haven't seen? I have just asked Mr. Mills, tax counsel, and he said that he never received a return.

The Court: For the year 1950?

Mr. Mills: The individual return.

Mr. Schessler: All right, your Honor.

We will go on.

(Testimony of Fray L. Hobson.)

Respondent requests that this document be marked as Respondent's Exhibit next in order.

The Clerk: For identification, Respondent's Exhibit H.

(Respondent's Exhibit H was marked for identification.)

Mr. Schessler: Your Honor, this is the individual income tax return of O. H. and Helen D. Kruse for 1951, and counsel for petitioner will object to this on certain grounds.

The Court: Have you offered it?

Mr. Schessler: I am going to offer it as Respondent's Exhibit H.

Mr. Yardum: I object to it on the grounds that [108] it is irrelevant and immaterial.

The Court: For what purpose are you offering it?

Mr. Schessler: To show the treatment by Mr. Kruse of the accrued rent and accrued interest.

The Court: The exhibit is admitted for that purpose.

The Clerk: Respondent's Exhibit H.

(Respondent's Exhibit H was received in evidence.)

Q. (By Mr. Schessler): Do you recall if you prepared the '51 return, Mr. Hobson?

A. Yes, I prepared it.

The Court: Let Mr. Schessler take it. It's an exhibit in the case.

Q. (By Mr. Schessler): I hand you Respondent's Exhibit H and ask that you look at Mr.

(Testimony of Fray L. Hobson.)

Kruse's treatment of income from income from rents, and after you have looked at that, I ask how much rent did Mr. Kruse report?

A. Twenty-one thousand.

Q. And how much interest? A. None.

Q. And that's another one of those errors that you were referring to in your exhibit about the '52 return? [109]

A. This should have been reported as—Yes, yes, sir.

Mr. Schessler: Respondent requests the Clerk to mark this document Respondent's Exhibit next in order.

The Clerk: For identification, Respondent's Exhibit I.

(Respondent's Exhibit I was marked for identification.)

Q. (By Mr. Schessler): Mr. Hobson, I hand you what has been marked as Respondent's Exhibit I for identification and ask you if you are familiar with that. A. Yes.

Q. And if you are, will you tell us roughly what it is?

A. It is a subordination agreement on the form of the Bank of America whereby—

Q. Just give us the date of it and then tell us what is the next one and I think that will be sufficient identification for my purposes.

A. Perhaps it wouldn't be for mine.

Q. Oh, I'm very sorry.



(Testimony of Fray L. Hobson.)

The Court: That's sufficient. You just answer counsel's questions.

The Witness: What was your question, sir?

The Court: He just asked you to identify it and [110] to the extent that he asked you to identify it, you identify it.

A. It is a subordination agreement dated November 3rd, 1951.

The Court: And the other one?

Q. (By Mr. Schessler): And the other, the attachment?

A. Corporation resolution to borrow, dated November 3rd, 1951.

Q. Thank you. Does that refer to the loan, the open line of credit that Mr. Kruse secured from the Bank of America?

A. Yes. These are forms that the manager of the El Monte Bank of America asked him to fill out.

Mr. Schessler: Thank you. Respondent offers these Respondent's Exhibit I in evidence at this time.

Mr. Yardum: No objection.

The Court: Exhibit I is admitted.

The Clerk: Respondent's Exhibit I.

(Respondent's Exhibit I was received in evidence.)

Q. (By Mr. Schessler): I believe you previously testified that Mr. Kruse borrowed money from the Bank of America?

A. The corporation did.

(Testimony of Fray L. Hobson.)

Q. Excuse me, I'm sorry, the corporation. [111]

Did Mr. Kruse execute notes for these amounts, these loans? A. Yes.

Q. Were these loans, to your knowledge, were these loans paid on time? A. Yes, sir.

Q. Do you have knowledge of that?

Mr. Yardum: Object to the question. The question has been asked and answered.

The Court: He may answer.

Mr. Schessler: I want to be sure that he knows of his own knowledge, your Honor, whether these notes were paid.

A. I know they were paid.

Q. (By Mr. Schessler): On time?

A. Without seeing the notes, I would not know what the due date was.

Q. You are familiar with Mr. Kruse's banking habits, you are familiar with all of his books, aren't you? A. Yes.

Q. Based on this familiarity, was it Mr. Kruse's habit to let notes to the bank and others go beyond the due date? A. No. [112]

Q. Was it his practice to make sure that all amounts owing to third parties were paid on time?

A. Yes.

Q. Did he frequently try to pay amounts within the so-called cash discount period?

A. Are you referring to trade creditors?

Q. Yes.

A. Yes. In his business, however, there is no discount. He paid on invoice, so your question—

(Testimony of Fray L. Hobson.)

Q. I'm glad you clarified the question.

I wasn't too clear on just how to phrase that.

Now this loan to Mr. Kruse of two hundred—note to Mr. Kruse of \$200,000.00, to your knowledge, were any payments made up through December, 1953 on it? A. None were made.

Q. Was this a secured—excuse me.

A. By that, you mean payments on principal, do you not?

Q. Yes; that is what I mean.

A. That was covered in the stipulation.

Q. Was this loan a secured loan? A. No.

Q. These assets, I believe, that the loan represented consisted of cash, accounts receivable and inventory.

Were those assets necessary to the operation of [113] Mr. Kruse's business at the — during the transition period? A. The specific assets?

Q. Not necessarily the specific assets, but assets such as cash, accounts receivable and inventory; was it necessary that he have any assets of that type in order to perform, or could he have gone—could the business have functioned with the assets that were exchanged for stock? A. Yes.

Q. It could have? A. Yes.

Q. Do you know, of your own knowledge, that this corporation has ever paid dividends?

A. It has not.

Q. Who were the owners of the stock that was issued in 1950, if you know?

A. Mr. Kruse and his wife.

(Testimony of Fray L. Hobson.)

Q. Were there any other stockholders?

A. No.

Q. At this conference that took place in the Judge's office, was the question of any other stockholders discussed?

A. Not at that conference.

Previously, he had discussed admitting two of his key personnel.

Q. Were you present when he discussed admitting of two of his key personnel? [114]

A. Yes.

Q. Did he do it?           A. No.

Q. One further question: Do you know when permission was received from the Corporation Commission to issue stock in this corporation?

A. The stock was issued in August. The date of the permit I do not know.

Q. Was it shortly before the stock was issued? I mean, shortly, I mean a week or two?

A. As a matter of fact, I could not say. It would not have been too long a time.

Q. I see.

A. The incorporation was handled entirely by Judge Wolford, and the dates and the delays and so forth I'm not—are not fixed firmly in my mind.

I took several months to complete it.

Mr. Schessler: I have no further questions, your Honor.

The Court: Have you anything further?

Mr. Yardum: Yes.

(Testimony of Fray L. Hobson.)

Redirect Examination

Q. (By Mr. Yardum): Mr. Hobson, did you, in your capacity as assistant secretary of the corporation or as accountant for [115] the corporation, advise Mr. Kruse on financial and tax matters?

A. Yes.

Q. In 1950 the corporation accrued \$9000.00 rent and \$9000.00 interest on its books.

The minutes show that their interest didn't start on the note until January 1st, 1951.

Will you explain how that interest was accrued on the books?

A. It was accrued by journal entry.

Q. I beg your pardon.

A. It was accrued by journal entry, as of July 31st, 1950.

Q. Well, I'm asking you what it was accrued for. Was it the interest on the \$200,000.00 note?

A. It was recorded as that, yes.

Q. Well, was it an error?

A. It should not have been accrued.

Q. In 1951 the corporation deducted \$12,000.00 rent and \$12,000.00 interest. That's correct, is it not?

A. Yes.

Q. And Mr. Kruse, on his personal return, reported \$21,000.00 rent.

Can you explain why that discrepancy?

A. No, other than to attempt to report the income [116] that he felt was necessary to report.

By so doing, an attempt was made to correct.

(Testimony of Fray L. Hobson.)

Q. This thousand dollars a month that the corporation was paying Mr. Kruse as rent, what was that for?

Was that for the Tyler Street mill?

A. It was for the Tyler Street mill. It was for another parcel that contained an office, a hay barn, and it was for another parcel that contained a warehouse.

Q. What's this R.R.S.T. mill mean in the 1951 return, Exhibit H?

A. That is—That is a building that he built to house milling equipment.

Q. Was he supposed to receive rent then in addition to the other rent, the thousand dollars a month?

A. The thousand dollars a month encompassed all of it.

Q. It was all of it?

A. Yes, all of the property that he leased.

Q. I am just trying to find out why he reported \$12,000.00 rent income personally in 1952 and in 1953 and \$21,000.00 in 1951.

A. The year '51 should have reported 12,000 interest and 12,000 rent, total \$24,000.00.

Q. It's an error then?

A. He reported 21,000 as income.

Mr. Yardum: O.K. I have nothing further. [117]

Mr. Schessler: I have no further questions of this witness.

The Court: That's all.

(Witness excused.)

Mr. Yardum: The petitioner has nothing further, your Honor.

Mr. Schessler: At this time, your Honor, the respondent has nothing further to offer but requests a five-minute recess in order to consider the possibility of a motion on the issues.

The Court: Very well. The court will take about a ten-minute recess.

(Short recess.)

Mr. Schessler: At this time, the respondent moves for decision as to one of the issues in question here.

With respect to the adjustments placed in issue by Item A of the statutory notice for 1952 and 1953, the interest deduction, it's apparent here that the pivotal point in issue is whether or not a bona fide indebtedness in these years existed between petitioner and O. H. Kruse.

The testimony that we have had on this issue has been directed entirely towards the form of the challenged indebtedness, and respondent doesn't question form.

The only person who has testified by the petitioner has given testimony actually in his capacity as [118] an accountant, bookkeeper, and he was not fully employed by petitioner.

He became an officer at some time during the, at least prior to the date of the trial.

His duties were to keep books and to file, as an officer, to file certain tax returns, and that only took him three days a month.

[Endorsed]: No. 16663. United States Court of Appeals for the Ninth Circuit. O. H. Kruse Grain & Milling, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: October 28, 1959.

Docketed: November 6, 1959.

/s/ PAUL P. O'BRIEN,  
Clerk of the United States Court of Appeals for  
the Ninth Circuit.

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United States Court of Appeals  
For the Ninth Circuit

No. 16663

O. H. KRUSE GRAIN & MILLING,  
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

POINTS RELIED UPON BY APPELLANT

The points on which appellant intends to rely on this appeal are as follows:

(1) That the promissory note in the amount of \$200,000.00 issued by appellant corporation to O. H. Kruse in payment for certain specified assets having an equal value was intended to be, and was, in fact,



evidence of a bona fide indebtedness of appellant corporation, and not a contribution to capital.

(a) In general.

(b) That the note had a fixed maturity date and was not a demand note, and, therefore, does not permit an inference that a bona fide indebtedness was not intended.

(c) That the fact that the Bank of America required appellant corporation to execute a printed form of subordination agreement does not leave a permissible inference that the payee of the note, O. H. Kruse, did not intend to enforce payment by appellant corporation.

(d) That the fact that appellant corporation's accountant made mistakes in connection with appellant's income tax returns should not be significant in determining whether there was actually a bona fide indebtedness of appellant corporation to O. H. Kruse.

(e) That the fact that the note was unsecured is not significant in determining whether there was, in fact, a bona fide indebtedness.

(f) That the fact that O. H. Kruse failed to testify at the trial is not a significant fact in determining whether or not there was a bona fide indebtedness of appellant corporation.

Dated: November 13, 1959.

/s/ LeVONE A. YARDUM,  
Attorney for Petitioner.

Certificate of Service by Mail Attached.

[Endorsed]: Filed November 16, 1959. Paul P. O'Brien, Clerk.

